

# The termination of the Russian oil transit to Ventspils in 2003

*Hwom to blame, if to blame anyone?*

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Master Thesis at the Department of Political Science

University of Oslo

Spring, 2010

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## Preface

This master thesis is a product of an ordinary curiosity. I am Latvian; and I do want my country be developed and wealthy. No academic knowledge is needed to understand that the termination of the Russian oil transit to Ventspils had a major damaging impact on the Latvian economy; the country where the main resource is its geographical location. The wish to find out what the explanation of this event can be brought me to Fridtjov Nansen Institute, where my supervisor, Arild Moe, made this intention to a 70 pages long thesis.

Therefore, my first and foremost *thank you* goes to you, Arild. To have a supervisor, who is fluent in Russian, my mother tongue, was a pleasure; but to have a supervisor that has a fantastic skill to guide a student through the academic and scientific challenges was pure luck for me!

I am also very grateful to Simon James-Eide, Carolyn Ferguson and Nicholas Vikør Green for helping me with the proofreading. Without you, I would not make it in time.

Last, but not least, I want to thank my three-years-old son, Emil, for his patience, and my husband, for supporting me and paying my bills.

Responsibility for any errors and inaccuracies is entirely my own. The word account: 23262.

Oslo, May 2010

Natalija Protosevicha

# 1. Introduction

Size, geographical location, natural resources and human development are among key elements by which countries differ. These factors are clearly important in shaping the choices available to national governments. Latvia does not have any gas or oil, but it does have a well-developed infrastructure system and well functioning ports on the Baltic Sea to transport energy to world markets. The transit of Russian oil through the Latvian seaport of Ventspils is the subject in this thesis.

Latvia is a small country situated on the cost of the Baltic Sea. The geographical location has played an important role in Latvia's history, recent as well as distant. Direct access to the core pan-European sea routes has influenced the economic development of the largest cities on the seacoast. Riga and Ventspils have since Middle Ages been important both as independent trade partners and as transit points for the goods coming from Russia. Later, being a part of the Soviet Union, Latvia benefited from big-scale modernization of the transport system, which made Latvian seaports even more important for the transit of Russian minerals to Western Europe (Smith et al, 1996:152). Transport corridors go across the country both from East to West and from North to South. Thus, the profitable geographical location and developed ports and transport infrastructure allows Latvia to be considered a transit country.

Transit is usually addressed as a sector in the Latvian economy. This is because most of the transport companies are in the business of processing transit freight, and transit implies a wide range of services, such as storage, transportation and custom procedures. Private companies working within this sector are significant taxpayers to the national treasury. Oil transit, in particular, has been historically important to the Latvian economy. Built in the 1960s, the oil pipeline system has been a safe and economically beneficial way of transporting oil to the European markets (Spruds, 2001:6). Furthermore, the oil transit remained to be a priority in Latvian economics since regaining independence in 1991 and the issues of transit policy were taken up to

the highest levels of government. Nevertheless, the oil transit volumes via the Port of Ventspils decreased sharply in 2002 and since January 2003, oil transit via Polotsk – Ventspils pipeline has been cut off due to the Russian Government Commission Decision of December 2002 (Regnum, 2003). Why a mutually beneficial agreement was broken, is a matter of uncertainty. This master's thesis aims to explain why it has occurred by finding out who were the main actors in the interplay around the break, what were their motives and actual behaviour.

## 1.1 Structure and the content of the thesis

The subject I am writing about is not so well represented in scholarly literature or recent debates as, for example, the Russian gas conflicts with Ukraine. Therefore, I will give a reader a brief presentation of main actors that were involved in the oil transit in Latvia as well as an empirical overview of the transit organisation. I will proceed with a theoretical framework and a brief discussion of methodological challenges and the operationalisation of the main concept. I will underline that the theoretical use is rather simplistic, thus, the presentation of the main theories will be short. My main suggestions for why the transit was terminated resulted in three hypotheses that will be presented in chapters four, five and six. The concluding chapter will be both a summary of the thesis and the discussion of the main findings. I will proceed with a brief presentation of the main actors in the transit business both in Latvia and in Russia.

## 1.2 Empirical background. What? Where? When?

The Latvian ports have historically been important in Russian trade. During the Soviet times, the infrastructure developed considerably, strengthening links between Central Russia and Baltic seaports, among which the Ventspils port became an absolute leader in transshipment (Liuhto, 2003: 31).



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After the break-up of the Soviet Union, Latvia and Russia had to re-adjust their relations in a new domestic and international environment. As the former state system vanished, the pipeline system remained and the shift in ownership brought some challenges to the further co-operation between Latvia and Russia. In the early 1990s, the Latvian transit sector experienced reduction of oil transit, caused by the disruption in transmission among former republics and a considerable drop in production in Russia. Nevertheless, the Baltic ports retained an extensive amount in Russian maritime trade transshipment. Ventspils port, which is the 12<sup>th</sup> largest in Europe and the most modern oil export port in the Baltic region handled more oil in transit from Russia than any other port in the region making Latvia the leading Baltic state in transit of Russian oil (Spruds, 2001:6). During the 1990ies annually 13-15% of all Russian oil and about 30% of all oil exported to the West (mostly Finland, Germany, the Netherlands, Belgium and Great Britain) was transported through Ventspils.

Latvia profited substantially from the Russian oil transit. An estimated one-fourth to one-fifth of Latvia's GDP was directly linked to transit and related branches.<sup>1</sup> In 1997, the annual income from oil transit in the national budget was estimated to 160 million USD (Spruds, 2001: 6).

Technically, trunk pipelines of oil and oil products together with oil terminals form the Latvian transit corridor of oil and oil products. The trunk pipeline system includes two crude oil pipelines and one pipeline for oil products. The oil pipeline Polotsk – Ventspils, with capacity of 16 million tons per year, was put into operation in 1968. The additional parallel pipeline of oil products with capacity of 12 million tons started operating in 1971. In order to supply the Lithuanian Mazeikiai oil refinery with oil, in 1980 the pipeline Polotsk – Birzai - Mazeikiai was put into operation. Up to Birzai the pipeline runs parallel to the Polotsk – Ventspils pipeline on Latvian territory (Spruds, 2001: 7).

It is not surprising that Latvian ports and infrastructure attracted a large part of state and private investments. Ventspils seaport has a maximum capacity to transfer 500,000 barrels a day. In 2001, it was operating with 320,000 barrels a day. The central actor in the oil transit business on the Latvian side is *Ventspils Nafta* (VN), the country's dominant oil transit company, based in the port of Ventspils. Growing competition from other seaports in the region urged VN to modernize. As a result, Ventspils Nafta invested USD 160 million into reconstruction and building of new reservoirs for oil storage and modernisation and renovation of the port in 1999-2000 (The Baltic Course, 2002). In 2002, Ventspils Nafta was owned by the Latvian State (44% shares) and the private company *Latvian Oil Transit* (48%). The *Latvian Oil Transit* was owned by *Ventbunkers*, which was the single largest shareholder in the conglomerate. It has been an attractive investment for foreign actors, as far as both the Russian pipeline monopoly *Transneft* and Russian - British holding *TNK-BP* expressed interest in purchasing shares in Ventspils Nafta (The Baltic Course, 2000).

Generally, Latvian ports and the transit infrastructure attracted international state and private capital inflows, of which Russian investment accounted for a considerable portion. This can be illustrated by the major Russian government investment in the Latvian transit infrastructure. *Transneftprodukt*, an affiliate of *Transneft*, obtained 34% of the capital shares of Latvian-Russian *LatRosTrans*, which is supervising the pipeline system in Latvia. Moreover, Russian investment sources were planned for further development and implementation of transit projects, such as the Western Pipeline System that aimed to increase the flow of oil to Ventspils. The largest Russian companies, such as *Lukoil* and *Yukos*, which had already made significant investments in the Latvian transit market, were eager to join the project (Spruds, 2001:8).

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<sup>1</sup> For example, in the year 2000, 80% of shipments of state-owned Latvian railway company, LDZ, were transit shipments. About 50% of these were oil and oil products mostly shipped to seaports. The profit of the company was estimated to LVL 2 million (Dienas Biznes, 2001:9<sup>th</sup> of January). LDZ is the largest employer in Latvia.

Hence, by the second part of 1990s, the transit relations between Russia and Latvia were active and mutually beneficial. Russian and Latvian transport and energy infrastructures were interlocked, and mutual interest in co-operation maintained through most of the 1990s. For Russia, the Latvian transit corridor was a reliable way to export crude oil and oil products to Western Europe, thereby providing a significant source of revenue to the Russian State.<sup>2</sup> Thus, it is possible to characterize the relationship between Russia and Latvia during this time period as economic interdependence.

However, the oil shipments to Ventspils dropped sharply in 2002 after Russia opened a new oil terminal at Primorsk near St. Petersburg in December 2001. Russia said the terminal would save US\$1.5 billion annually in transit tariffs, most of which previously had paid to Latvia (Lyons, 2003). Thus, because of this development the transit relationship between these two countries switched from co-operative to competitive.

While the Russian authorities pointed out the economic aspect in the decision to terminate the transit, the Latvian state saw on it as an act of political pressure. How we can explain this decision and which theoretical instruments can be used to do it will be presented in the next chapter.

### 1.3 The choice of the case

The case of the oil transit termination to Ventspils was initially chosen because it shaped the economy of the country I am coming from.

Meanwhile, according to King, Keohane and Verba (1994:15) any researcher should aim to meet two main criteria. Firstly, the topic must be interesting and important. The

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<sup>2</sup> The oil and gas sector generates 25% of the state` industrial production, giving 38% of the budget revenues (Spruds, 2001:7)

oil transit is perhaps most interesting to scholars within petroleum studies, however, the economic impact it had for the every day life of an average Latvian makes this case relevantly important for the general audience. This in-depth study of the transit of Russian oil can be also embedded in a wider study of Russian energy policy towards international partners.

Secondly, King, Keohane and Verba (1994:16) argue that the research project should contribute to the existing scholarly literature. Making this contribution can be done by, for example, choosing a hypothesis, which no one previously has completed a systematic study. The oil transit to Latvia and, particularly, its termination in 2003 was heavily discussed in Latvian, Russian and even European mass media, but I could not find a systematic study of the causes to this event. The Russian transit policy is also widely discussed in the literature, where the scholars strive to convince the reader in either political or economic underpinning of the Russian energy policy. However, according to my experience, the case of Ventspils is mentioned rather rare, and then, mostly by Latvian scholars (see Spruds 2001).

I will now proceed with theoretical framework for the study and present three hypotheses for explanation of *why the transit of Russian oil through Latvia was terminated in early 2003*.

## **2. Theoretical framework**

The main purpose of this thesis is to explain why a mutually beneficial agreement on oil transit was broken. Three main questions need to be answered: who were the main actors; what did they do; and why?

The energy sector lies on the borderland between politics and economy. It is therefore necessary to understand how much political versus how much economic influence was in the decision to stop the transit. Furthermore, it is necessary to find out on which level the decision was made and what the driving forces behind it were.

Several theoretical concepts potentially have explanatory value in understanding this event. Realist theory can serve as a fundament for potential answers to this question. Realism is a “state-centric” view of international relations and considers nation-states to be unitary, rational and profit seeking actors (Smith&Webber, 2002:14). The central concept of realism is that the defence of national security ensures state survival in an anarchic international state system with no overarching authority. Power maximising by securing military strength is the way to reach these objectives. Moreover, Morgenthau defined national interests in terms of power and argued that nation states pursue national interest as their main objective, thus the driving force behind foreign policy is a quest for power (Orban, 2008: 26). These premises form the basic framework for the rational unitary actor model, used by Graham Allison. I will use this model first, to explain why the agreement was broken.

However, realism has been criticised by its simplistic way of looking at foreign policy making (Smith&Webber, 2002:14). Among other considerations, two major assumptions of realism have been an issue of debate. First, realism’s state-centric view of international relations eliminates the importance of other than state governments in foreign policy making. Second, realism’s narrow understanding of foreign policy puts national security at the head of foreign policy agenda; thus, its

ultimate expression of national security is the ability to ensure military security for the territory and its citizens (Orban, 2008:13-15).

Neoclassical realism provides another view on the driving force behind state behaviour on the international arena. It underlines the necessity to understand both domestic considerations and international constraints in explaining states' behaviour in international relations (Alons, 2007:211). Neoclassical realists also assume that the primary actors in the international system are states that act as independent units, but the leaders of the states do not necessarily have freedom to direct their states' resources in the direction found necessary to secure national interests. This is mainly because neoclassical realists have a wider conceptualization of power. They describe power not in military terms, like classical realists do, but rather as "capabilities of resources" with which states can influence each other (Orban, 2008:21). Neoclassical realism will be used as a theoretical framework for my third hypothesis, where I link Russian politics to its external policies. However, while it is important to highlight the theoretical application of all three models, it is rather simplistic, as I use only core assumptions and it is beyond the scope of this paper to compare or test these theories.

## 2.1 Classical realism and the Rational Actor Model

Attempting to analyze the reaction of American government to the placement of Soviet missiles in Cuba in the autumn 1962, Allison formulates a set of assumptions that forms three main explanatory models. His first model, the so-called *Rational Policy Model* (RAM) is the easiest to understand.<sup>3</sup> In essence, it contains the main propositions of rational choice theory and traditional realism. According to this model, a nation can be treated as a unitary actor with a set of goals and the ability to pursue these goals. The actions taken to realize national goals are accurately calculated with respect to the balance between the cost and the benefit of these

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<sup>3</sup> Rational Policy Model has been redefined into Rational Actor Model in Allison's and Zelikow's *Essence of Decision: explaining the Cuban Missile Crisis*. 2<sup>nd</sup> Edition (New York: Longman, 1999)

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actions. Drawing on the traditions of classical realism, RAM defines a nation's head of state or head of government as the unitary personification of a state (Allison, 1969: 693-694).

The main interest of any state is its survival (Souva, 2005: 152). To defence national security is, therefore, the prior objective of the state and the main estimate for the choice of the options to resolve national problems. From the perspective of the RAM model, international relations are the interplay between unitary nation states that act on a rational basis; that is, they strive for utility or value maximization. Nations select the actions with the best cost-benefit ratio. This model has its roots in rational choice theory and traditional realism. Both its power and its weakness lie in its simplicity. The model is supported because it has basic realistic assumptions of value-maximizing state behaviour. On the other hand, it is criticised for its overly simplistic look on rationality, static selection of problem-solving options and exaggeration of its instrumental capacity (Bendor&Hammond, 1992: 306-307).

### **2.1.1 Rational Actor Model applied**

One can argue that the termination of oil transit was caused by tensions in foreign policy between Russia and Latvia. More specific, Russia was constrained with the changing balance of power in the Baltic region and wanted to regain its position. The pursuit of national interests (which is national security and, consequently, a continuous quest for power) would in this case be the core explanation for the decision made by the Russian government. In order to reach this goal, Russia could be interested in manipulating the political situation in Latvia. A hard power instrument, as military attack, was not an option, so the economic power could have served as a suitable instrument to influence Latvian politics.

As Huntington importantly points out, the economic relations are not only about absolute gains, relative gains also matter; a state may refrain from economic co-operation if it believes it may gain more from non-cooperation. That is, "economic activity is a source to power. It is, indeed, probably the most important source of

power, and in the world in which military conflict between major states is unlikely, economic power will be increasingly important in determining the primacy or subordination of states” (Huntington, 1993: 71).

Thus, if the rational actor model could explain the termination of transit, it would mean that Russia wanted to regain control over the region and economic pressure was a tool to achieve it. To find whether the transit termination correlates with the national foreign-policy trends, it will be necessary to examine the interplay between national key actors, like governments, and find linkages to economic pressure. Rational actor model presupposes that Russia was acting unitary and that it had particular expectations to what the Latvian reaction will be. Thus, it will be necessary to examine whether the state was acting as a unitary action and what was the motivation, the purpose to terminate the transit.

One could argue that the political leadership in Latvia was particularly hostile to co-operation with Russia at the time that the agreement was halted. The nationalistic atmosphere, as well as the anticipation of EU and NATO membership, could arm the Latvian government with more confidence that caused it to react in a manner that was not economically rational. It is therefore necessary to examine the overall picture of the bilateral relations and political milieu in Latvia in the time period of the transit breakdown. The hypothesis I outline is the following:

*The oil transit was stopped because of a Russian objective to defend its national interests.*

## 2.2 The pluralistic decision-making models

The essence of this explanation could be found in a quite different theoretical approach. Allison’s evaluation of decision-making process resulted in the identification of three main models: the Rational Actor Model, the Organizational Behaviour Model (OBM) and the Bureaucratic Politics Model (BPM). The second



two models combined, make up what is known as the bureaucratic politics model. Although these models have some peculiarities and are not identical, the logic of highly differentiated decision-making structure and the pluralism of actors unite these two models. Consequently, these models are used simultaneously when I explain why the transit to Ventspils has been turned down.

In the Organizational Behaviour Model, international relations are seen as a result of the interplay between the myriad of organisations constituting the state. This “conglomerate” of loosely allied organizations is often headed by a single leader or a government, but instead of acting as a unitary autonomous actor, the government acts through organizational sensors it perceives. Modern governments are comprised of numerous organizations. Each of these has its unique culture and particular agenda. These organisations participate in the daily decision-making of the state. The way each organization contributes to the decision-making is limited by a range of factors, such as organizational culture, inflexibility of bureaucracy struggling for budgetary resources and inter- and intra-organization communication. These factors shape the way in which government agencies react to current issues. Governmental behaviour can be therefore understood as outputs of large organizations functioning (Allison, 1969: 698).

Like the OBM, Allison’s bureaucratic politics model focuses on the sub-state actors. Allison describes decision making as the outcome of bargaining and political competition between state key policy makers (Allison, 1969: 707). In this model, Allison describes the state decision-making as the bargaining of many individual actors, each with its own notion of what national goals are, and each with its personal desires and ambitions. These actors share power and exert a degree of influence due to its positions in the government hierarchy, formal and informal relationships with each other, and the nature of the issue being addressed. Although these actors often disagree on what the best decision is, the policy is resolved by competitive politics. In short, government decision-making is not a clear process, but rather it is a result of

“compromise, coalition, competition, and confusion among government officials who see different faces of an issue” (Allison, 1969: 707-708).

### **2.2.1 Pluralistic model applied**

The rational actor model and realism in general have been criticised for their simplistic way of foreign policy-making and steady allegiance to the idea of a national state as a unitary actor. According to an alternative model--the pluralistic one--decisions in foreign politics are made through the process of bargaining, competition and compliance of multiple sub-national actors. Private companies, bureaucrats, political elites and institutions are the key actors in the decision-making. All of these groups may have different goals and different assumptions of what means should be used to achieve these goals (Allison, 1969: 697-698). The explanation of causes that lead to transit stop may therefore be found in the examination of the interplay between various sub-national Latvian actors. That is, the events on the Latvian sub-national level could have provoked the reaction to terminate the oil transit. The price and organizational patterns around the transit could be the factors that influenced the Russian decision.

If one applies the Organisational Behaviour Model to explain why the transit was terminated, one can assume that the Latvian governmental behaviour expressed through state organisations has shaped the established transit patterns that could have provoked the decision to stop the transit.

All these considerations lead to the assumption that the cause of the oil transit termination could be found by examining the bargaining patterns of different sub-national actors. The alternative hypothesis I outline is:

*The stop of the oil transit was caused by development on the Latvian sub-national level.*

## 2.3 Neoclassical realist theory. The model of internal and external polarity

Finally, in order to explain the transit termination, we can examine the complexity of relations between Russian national government and Russian oil companies, assuming that these had different interests in the oil transit.

As was argued previously, the realist explanation of the foreign policy decisions can be criticized for its simplistic way of looking at international relations. The neoclassical approach has a broader perspective of foreign policy making as a starting point. The basic idea is that foreign policy decisions are influenced by domestic constraints and the distribution of power on the international arena (Orban, 2008:20). To explain how the internal and external politics intermix, and under which conditions one predominates over the other, is a central task of neoclassical realists.

Among important approaches combining domestic and international politics, one can mention poliheuristic theory, which works from the assumption that foreign policy preferences and decisions are the result of an evaluation of country's military, economic, and political dimensions (Alons, 2007: 213).

Using poliheuristic theory as a starting point, Alons focuses on the distinction between dimensions reflecting domestic considerations and those reflecting international considerations (Alons, 2007:214). In his work, he identifies which dimensions are essential under different circumstances. This is done by using two variables: the polarity of the domestic system, or the internal polarity, (i.e., "the degree of concentration of power in the hands of the government" relative to other actors) and the polarity of the international system ("the degree of power concentration in the international system"), called external polarity. As neoclassical realists do, he argues that states are sensitive to both domestic and international constraints when they formulate foreign policy decisions, as they want to avoid decline in their international position but also that "governments wish to remain in office" (Alons, 2007:212). Furthermore, high internal polarity will give the state

leadership more freedom to manoeuvre in the international arena than the low polarity could have done. More specifically, the lower the degree of institutionalization within the state and the higher the degree of power centralisation within the decision-making actors, the higher the internal polarity. Robert Putnam has also used this argument in his two-level game model, the one that I have used as a starting point for my third hypothesis in the early stage of hypothesizing. However, I decided to use Alons's model of internal/external polarity when it came clear that two-level game is not the best theoretical framework.<sup>4</sup>

While, Alons admits that the overall goal of a state is its survival, as classical realists do, he uses three important dimensions of the interest in survival, introduced by Van der Vleuten, namely: political, economic and ideological dimensions (Alons, 2007: 214). The political dimension covers a government's objective to remain in office, and for the state, it implies safeguarding its position from other states in the international arena. Wealth is a central aspect of the economic dimension, as states have to struggle for their share in world markets. Finally, the ideological dimension of national interest touches upon national role-perceptions, as the states have particular roles they want to play in the international system. Furthermore, the political interest of survival can be regarded as dominant over other interests, as security is prerequisite for state to be able to strive for economic and ideological goals. Therefore, a state will maximize economic benefits as long as this does not compromise its political interests (Alons, 2007: 215). Since individuals are making concrete foreign policy choices, it is necessary to incorporate their perception regarding what power capabilities may be used to defend those interests, and their perception of international events and how they translate them into concrete action. Additionally, neoclassical realism differs from classical realism in terms of motivation of states behaviour. It claims that states

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<sup>4</sup> Two-level game of Robert Putnam has been used as a theoretical ground for the analysis as a starting point, highlighting that the decisions considering international outcomes can be influenced by the interplay between state and private actors. The model has been turned upside-down, as I have concentrated on the factors that do not increase but decrease the win-set of the parties. However the main idea in Putnam's two-level model has been the necessity of domestic ratification of the decision made on the international level, the idea that is absent in my hypothesis.

do not expand to acquire more resources (as in the classical realist school), but expand because of material resources (Orban, 2008: 20-21), which in this case is the oil.

### **2.3.1 Neoclassical realism applied**

Neoclassical realists highlight that domestic incentives and international constraints shape foreign policy preferences. They also emphasize that the main motivation behind foreign policy decisions is a wish to increase power (Orban, 2008: 22). Consequently, a classical neorealist would predict that by stopping the oil transit to Latvia, Russia seeks to enhance its power, both on the domestic level--making oil companies more dependent on the state-- and on the international level, as the oil industry is important both for the national economy and for national security. The underlying assumption of this statement is that the best way for Russia to enhance its international influence is to increase its economic strength and managing the oil industry could serve as a tool to achieve this goal (Orban, 2008: 23).

Therefore, the application of the model of internal/external polarity to the transit case results in three main assumptions. Firstly, the greater the capability of the Russian state to impose its will on the oil companies, the higher the internal polarity, e.g. the degree to which power is concentrated in the hands of the state. Secondly, the stronger the power concentration within the state, the more room for manoeuvre there is for actions taken at the international level (Alons, 2007: 216). Consequently, the high internal polarity is a necessary element to enhance power on the international level, which is a long-term goal for Russian state leadership (Putin, 2005a). Finally, one can assume that the economic interests of the private oil actors challenged the political interests of the Russian state; that is, its wish to regain its international position as a powerful player. Thus, the state was interested in controlling the transit sector, so that the economic interests would serve the political one.

Overall, the importance of increasing the internal polarity, i.e. state control over the petroleum sector, is linked to Putin's perception of economy as an important tool to

regain powerful position on the international arena. In other words, state power consolidation is necessary for the state to be strong actor behind its national borders. I will meanwhile not discuss the international ambitions of the Russian state, as it is beyond the subject of this thesis. However, this assumption is important to understand why Russia reacted as it has done. The third hypothesis I outline is therefore:

*The stop of oil transit to Ventspils was caused by power consolidation over the oil industry in the hands of Russian state as a means to achieve a long-term foreign policy objective, that is, to increase Russia's international influence.*

## 2.4 Summary

Three theoretical approaches were used to formulate hypotheses that could explain why the oil transit to the sea port of Ventspils was terminated.

The point of departure for my first hypothesis is classical realism and the rational actor model. Realism is a state centric theory, where the state struggles to survive in international anarchy, making power both an instrument in this struggle and its ultimate goal. National security privileges all other state interests, which is also central in Allison's rational actor model. The application of this model resulted in a prediction that the Russian security interests, e.g. to regain power in the Baltic region, could have influenced the decision to stop using Latvia as a transit country. In other words, the decision is an outcome of foreign policy between Russia and Latvia.

I have used Allison's pluralistic model as a starting point for my second hypothesis. The focus changed from high politics to domestic politics in Latvia. The main assumption here is that the events on the Latvian sub-national level--be those economic conditions of transit or patterns of ownership--could have provoked the reaction to stop the transit. The models were used in a most simple way, as I have employed only the core argument that the variety of sub-national actors and the interplay between them can have an impact on external relations.

Finally, I have suggested that the transit break can be understood as a subordinate product of Russian internal energy policy. Neoclassical realism and the model of internal/external polarity have worked as a base for this hypothesis. I have suggested that the reorientation of Russian petroleum policy has caused the transit stop. Moreover, this decision is an expression of general principle to avoid third parties in oil transit. The underlying motivation here is the perception of economic strength as an important tool to regain Russian international power.

Before starting with the empirical analysis of my hypotheses, I will discuss methodological challenges and operationalisation of the main concepts.





### 3. Methodological approach and operationalization

#### 3.1 Case study research in Political Science

According to methodological criteria, this master thesis represents a case study class. Political science has no single definition for what a case study is. What it means varies across disciplinary subfields. Whereas textbooks describe “the case study” as the most common method of analysis in political science, these words are used to refer to a range of meanings and usages that vary from specific methods to research approach. Gerring, for instance, defines case study as an “intensive study of a single unit with an aim to generalize across a larger set of units” (Gerring, 2004: 341). Yin understands this method as a small N, qualitative, ethnographic and process-tracing research (Yin, 2003: 31-34). However, most scholars do agree that a case study aims to make a qualitative in-depth study of a particular unit with an ambition to understand a larger class of similar units. The case study researchers do not necessarily look for the universal, generalizable true, nor do they focus on cause-effect relationships; instead, they emphasize the necessity of exploration and description. To answer why could be found indirectly, by detailed examination of particular event development.

There are several applications for case study methods – illustrative, exploratory or explanatory method (Andersen, 2005: 68). The method that is used in this thesis is explanatory. This kind of case study is often used to test *why* or *how* a question, which in this particular case is why the transit of Russian oil was stopped. In the explanatory case studies, it is usually to isolate the unit (the phenomena, the process or the event) within the context of a particular theoretical approach. The aim is not to test or to develop a theory, but rather to apply the existing explanation (Andersen, 2005: 30-31). In this case, the application of neoclassical realism and unitary/pluralistic models will give me an opportunity to a better understanding of why the oil transit stopped.

Case study method is both widely supported and widely criticised. The supporters underline the utility of going to the core of an examined phenomena and in-depth study that bring more knowledge on the field, while the critics point to the challenges when reliability and measurement validity is valued, as well as to a small-N problem<sup>5</sup>. So, one might wonder why this method is widely used in political science?

First, the case study method gives a scholar almost unbounded freedom to research design. While statistical method obliges to follow strict mathematical rules, coding and standard operations, the case study can be “fuzzy around the edges” (Gerring, 1994: 346). Most case study advocates point out that case study, as any other qualitative methods of research, are able to produce much more detailed information than what is available through a statistical method. One can argue that case studies are able to deal with situations that are unique, context dependent and heterogeneous; and seek illumination and understanding of one single particular event (Andersen, 2005: 61). Consequently, the transit policies and the break of the oil transit through Latvian territory can be explained by detailed examination of actors’ behaviour and motives taking into consideration historical and political context. Although one may say that case studies enjoy a relative degree of freedom, the researcher must be concerned of the issues of reliability and validity.

Reliability refers to the stability, accuracy and precision of measurement. The researcher should ensure that the procedures used are well documented and can be repeated with the same results over again (King, Keohane, Verba 1994: 167). The choice of information sources and the use of them in the composing may also affect reliability. Throughout the whole thesis, I have been cautious to refer to the sources that I have used, providing for the verifiability of my assumptions. The data used in this thesis stems mostly from the secondary sources. The book of Anita Orban is a

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<sup>5</sup> Small-N problem is referred as an impossibility to generalise knowledge that is aggregated from the study of one single case where researcher usually examine one or close to one unit. The problem of generalisation can be explained by the weakness in representativeness, the degree to which casual relationship evidences by the single unit may be assumed true for a larger set of units (Gerring, 1994:348).

central book in this thesis. I have also used several scholarly articles, reports from research institutes, making the spectre of information wider.

Validity determines whether the research truly measures that which it was intended to measure or how truthful the research results are. It is common to divide between external, internal validity and face validity. Face validity involves a subjective evaluation of the indicator using logic, common sense and (or) expert opinion. The external validity refers to the extent to which the results of the particular study can be generalized, while the internal validity refers to the rigor with which the study was conducted, for example, research design or decision concerning which variables should be or not taken into analysis (Adcock&Collier, 2001: 530-533). This type of validity has been often a source of criticism because of potential investigation subjectivity. Yin proposed several operations to counteract the subjectivity. One can use multiple sources of evidence; establish clear chains of evidence or use pattern matching techniques. The sources of evidence can be archival records, documents, interviews, direct or participatory observation and physical artefacts (Yin, 2003: 93). Validity is especially important during the data collection phase and during the composition period. One must search for a consistent correspondence between the operational and conceptual definition, with other words that one measure what it was supposed to measure.

Testing my hypothesis requires to find valuable measurement of the independent variables that are defined in three different hypotheses. Firstly, I need to define the core elements in my hypotheses in order to develop some way of measurement of each of them. The information that I have collected should give me a platform for finding such operationalisation. How reliable these data are is a crucial for credibility of a scientific research. To minimize the risk of subjectivity and to control bias, I tried to use several sources of evidence that were close in time (Kjelstadli, 1992: 172).

## 3.2 Operationalisation

The idea of operationalizing a concept means the ability to transform a general abstract idea into something that can be defined and measured, with other words it constitutes a valid transformation of the studied phenomena in that way that allows it to be reliably measured (Adcock&Collier, 2001: 530). This can be achieved by defining dimensions to the concept and their indicators. Operationalisation is closely connected to internal validity, as it is a part of research design and composition.

Unfortunately, not all concepts can be easily operationanlised and thus the validity of the indicator can be challenged. One way to resolve this problem is to use multiple indicators each of which is a partial operationalisation of the concept. How valid and reliable these indicators are can be evaluated in several ways. Theoretical relevancy is a key factor when choosing the indicators, although expert consultation, logic and common sense, source triangulation, consideration of all perspectives can also contribute to higher better operationalisation and higher validity (Adcock&Collier, 2001: 537).

In this thesis, I intend to understand *why a mutually beneficial transit agreement was broken*. The focus is not only on the very decision to stop the oil flow, but also on the conditions that brought about the break. How should I interpret the *why* question in this case? It seems logically to suggest at least three explanations by defining dimensions along which the transit stop can be interpreted.

What kind of information will be necessary to investigate the first hypothesis? The Rational Actor Model claims that the foreign policy outcomes are determined by the government's objective to defend national interests. I assume that it will be necessary to depict the general atmosphere of the bilateral relations around the time period of the stop and the political moods within Latvian politics that could create the negative influence on the oil transit. Qualitative text analysis of the foreign policy documents, official statements and the description of political milieu in Latvia in the late 2002 and the beginning of 2003 will provide necessary indication on the quality of the foreign policy between Russia and Latvia.

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Allison's pluralistic model is the next alternative theoretical concept to the operationalisation. Instead of defining the relations on the top national level, I shift the focus to the interplay on the Latvian domestic level. Making a measurement implies the existence of a constant. In this particular case, this constant can be understood as established economic conditions to the oil transit. That is that a rapid **shift** in the price and (or) the organizational patterns around the transit could determinate the decision to stop the oil flow to the port of Ventspils.

Finally, neoclassical realism and the model of internal/external polarity will be used as the third theoretical ground for the operationalisation. The disagreements between the Russian state authorities and oil companies could have made an impact on the state decision to stop the transit. The transit stop can therefore indicate the wish to get more control over what is considered as a vital national interest in Russia, the oil industry. The power consolidations over the oil industry will in this case serve as an indicator of internal polarity. The external polarity will be expressed by the power distribution in the Baltic region specifically and on the international arena in a wider perspective. Consequently, it will be necessary to find indicators on fact that Russian authorities had disparities in transit issue with the oil companies and indicators that could describe Russia's standing on the international arena. The way to do this will be the examination of official expressions made by top politicians and analysis of the literature that describes of relation between the state and the oil companies in 2002-2003.

What is common for all these suggestions is the importance of defining the correlation between the change that happened in the transit process and the changes in political, economical or domestic policies of strategic importance. If such correlation does exist, one can discuss whether there is a casual relationship between the transit termination and the explanations suggested in my hypotheses.

I will now turn to the empirical discussion of my first hypothesis.



## **4. Russian national interests and Foreign Policy tensions in the Baltic region**

In this chapter, I will discuss whether the foreign policy tension between Latvia and Russia could have had an impact on the oil transit. The main objective is to distinguish the difference between the so-called “base land” and the new developments in foreign policy between Latvia and Russia. Therefore, I will first provide an overview of relations between Russia and Latvia in the period around the termination of the transit with the focus on Latvian national policymaking and the political milieu at that time, as these domestic factors have influenced foreign policy in regard to Russia. Therefore, I will try to define whether there was a change in political relations and if the time can be correlated to the transit cessation, as my first hypothesis states that the oil transit was terminated because of Russia’s objective of defending its national interests. Allison’s unitary rational actor model will be used as a theoretical framework for this analysis.

According to the RAM foreign policy making is conditioned by the outcome which has highest value to national security issues, thus foreign policy decision is a result of rational value-maximising behaviour, where the domestic political influence has no impact on (Allison, 1969: 694-695). To consider the rationality in the decision to terminate the transit would involve having an insight in the decision making process of the Russian Government Commission, which was not an option for me. Therefore, I focus on the highlighting that there were the Russian national security interests that influenced the decision.

### **4.1 Latvian-Russian relations in a wider spectrum**

The formation of Russian-Latvian foreign policy is determined by several factors. To begin with, it is necessary to remember the historical context of the relations, which has created complexity and assertiveness.

Historically, Latvian foreign policy has been preoccupied with Russia—a preoccupation that has been bitter (Pridham&Vanhanen, 1994: 34). After regaining independence in 1991, Latvia's foreign policy course has been constantly directed towards multilateral organisations, such as NATO and the EU, as well as integration with the West. The Latvian idea of “returning back” to Europe is synonymous with the idea of “maximizing” the distance from Russia. Thus, the idea of *salvation* of everything Russian has dominated the political and social debate in these countries during the late 1990s. Despite the geographical proximity to the Russian Federation, Latvian foreign policy took the course of distancing itself from Russia.

However, from the Russian perspective, geopolitical changes in the Baltic region have signalled the need for Russia to re-secure its status. The loss of strategic bases and ports in the Baltics gave Russia a heightened sense of vulnerability. As a result, Russian foreign policy in the Baltic region is security-related. The point is that both sides have a different perception of the national interest. The Latvian side sees Russian foreign policy as constituting a security threat for them. Shortly, what the Russian government perceives as its legitimate national interests is viewed by Latvians as “neo-imperialistic thought” (Stranga, 1998: 4-7). To understand *why* the relations have been complicated goes beyond the scope of this thesis and I find it more appropriate to define *how* foreign policy relations have been.

Alongside the historical context, the political milieu in Latvia and in Russia is a matter of importance. As Allison underlines, the main actor in the international arena is the state's leadership, which acts rationally according to national interests. As far as state survival is the main national interest, it implies that these interests are a **permanent** base land from which national foreign policy is being formed. However, when the national interests are permanent, the instruments of foreign policy making, by which these interests are realized, are more flexible. For instance, the political atmosphere in the country can influence the choice of the foreign policy instruments (Bendor&Hammond, 1992: 306). It is therefore necessary to describe political mood of the Latvian government in 2002.



#### 4.1.1 Political milieu in Latvia

The elections to the Latvian Parliament, the Saeima,<sup>6</sup> in 2002 were won by center/center-right political parties plus the one leftist party, *For Civil Rights in a United Latvia (PCTVL)* that also enjoys strong support Russian minority support. After a month of negotiations, four parties reached an agreement to form a coalition led by the New Era leader, Einar Repse. The coalition, which controlled 55 of 100 seats in the Saeima comprised the New Era, the Union of Greens and Farmers (ZZS), the Latvia First Party (*LPP*) and For the Fatherland and Freedom/LNNK (*TB/LNNK*) (The Central Election Commission of Latvia, 2003).

Looking at the portfolios of the parties, the elections of 2002 were won by parties that can be defined as ideologically conservative, nationalistic, “right-of the centre” and “Russian exclusionary” parties (Bugajski, 2002). The result of the election could be also understood as a **continuation of the established pattern** of post-Soviet Latvian politics, as all governments after 1993 were centre-right and pursued the same objectives. Thus, there has been continuity in foreign policy affairs.

Andrew Moravcsik (1998) places strong emphasis on the role of domestic factors in foreign policy choices. The state has preferences, defined as fundamental strategic calculations of the government. These preferences are dynamic and transforming rather than static, and could be purposefully altered over time According to him; powerful elites may influence the formation of state preferences, as Moravcsik points out that “preferences reflect the objectives of those groups which influence the state apparatus” (Moravcsik, 1998: 24). This argument echoes in the limitation that Bendor and Hammond have emphasised in evaluating Allison’s rational actor model and its preoccupation with the idea that national security policies remain static no matter what political colour the government has. The time aspect is important in foreign

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<sup>6</sup> Saeima is the national parliament of the Republic of Latvia. The unicameral parliament has 100 members who are elected in general, equal, direct proportional elections for a four-year period.

policy affairs as it may determine what instruments and choices the government has to achieve its core security objectives.

After the election of 2002, the Latvian political leadership was formed from pro-European, nationalistic elites that supported EU and NATO membership as a joker in the electoral campaign. The defence budget was gradually increased and the Latvian Foreign Ministry used diplomatic resources to bring the country closer to the NATO membership. All of these factors do matter when we examine foreign policy towards Russia, because the NATO enlargement had been a matter of national security to Russia.

In order to explain the Russian reaction to end the oil transit one should focus on the qualitative change in the relations. When it is clarified that foreign relations between Russia and Latvia were generally problematic, is it possible to state that those relations became more complicated in 2002-2003? To answer the question we must consider the most important confrontations in the negotiations around the border declaration, the citizenship and status of the Russian-speaking population and Latvia's NATO application.

## 4.2 Good fences make good neighbours. The border declaration between Latvia and Russia

The manifestation of their national border is a central for any country's security. Russia and Latvia started border negotiations just after Latvia gained its independence in 1991. In 1997, the two countries completed their negotiations regarding the state border but they apparently took different positions. Latvia wished to gain "historic justice" in regard to Soviet occupation and its statehood continuity with the pre-war Latvia, which Russia could hardly accept (Stranga, 1998: 6). The coalition parties of the Latvian government were eager to reinforce national self-awareness and were determined to get Russian acknowledgment of the unfairness of the Soviet occupation; therefore, the negotiations around the border treaty could have

represented a test of their patriotism, which is important in a country where ethnic issues are dominating the electoral campaigns. However, Russia has been explicit in its concern over the rights of the Russian-speaking minority, and underlined the unresolved problem as an obstacle to co-operation in the border negotiations. As a result, the resolution of the issue postponed.<sup>7</sup>

Interestingly, the lack of a border treaty did not stand out as an obstacle to Latvia to joining the EU, as the country received an official invitation in December 2002. Although the EU has implemented particular policies that should have stipulated Latvia to open border disputes (Joenniemi in Stetter et al, 2008: 134-140). As mentioned above, the negotiation of the border treaty was often postponed due to Russian dissatisfaction with Latvia's Russian minority issues. The requirement to speak fluent Latvian has been an obstacle to the activity of Russian-speaking residents in official political life, and was an obstacle in negotiations with Russia. Notably, after getting an official invitation to join the EU, the Latvian government abolished a controversial provision in Latvia's law that required electoral candidates to be fluent in Latvian. By doing so, Latvia strengthened its bid for full membership in the EU. Shortly afterwards a Russian politician, Mikhail Margelov, made a statement that both countries are on the way to signing the treaty, as their common work begins to show some progress. However, he did not give a specific date when this would happen (Neatkariga, 2002).

To sum up, the negotiations of the border treaty between Latvia and Russia were affected by disagreements regarding historic interpretation, Russian minority issues, and Latvia's application for the membership to the EU and NATO. Although, the

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<sup>7</sup> The border agreement was expected to be signed on the May 2005, but the Russian Federation refused to sign after the government of Latvia had adopted a unilateral explanatory declaration. This declaration made a reference to the Peace Treaty between Latvia and Russia back in August 1920<sup>7</sup> which pointed that Abrene district in the east Latvia was a Latvian territory

general conditions for negotiations remained the same throughout 2002 and 2003, the official invitation to join the EU—with its *acquis* membership pre-conditions—forced Latvia to abolish the Latvian fluency requirement for those who want to run for election.

### 4.3 The citizenship

Generally, inter-ethnic relations and minority rights are among the most controversial and problematic issues in the post-Soviet area. Migration during the Soviet time led to a large numbers of Russians settling in Latvia (particularly in the late 1940s). After restoring its independence in 1991, the Latvian legislature introduced restrictive citizenship legislation (Spruds, 2000: 13). As a result, a large number of Latvian residents do not meet the citizenship criteria according to the Citizenship Law of Latvia. These residents fall into a category of so-called ‘non-citizens’. Non-citizens in Latvia stand for approximately 22% of a total population (Rose&Munro, 2003: 197). Naturalization is a very slow process, which can be explained by the complexity of psychological and practical barriers. The legislation requires passing exams in Latvian language and on Latvian history. Thus, the Latvian language proficiency requirement is often considered the main obstacle in naturalization.

In 1998, in an attempt to solve the problem, the Latvian government introduced a program of bilingual education in Russian state schools<sup>8</sup> with a gradual transition to the school system with Latvian as the only language. The program was motivated by the fact that the Russian schools were fostering segregation of the educational system, which led to discrimination of the Russian-speaking students when they entered the labour market or applied for higher education. Because the number of courses taught in Latvian was relatively small, no objections raised (Spruds, 2000: 17). However, in 2002, the government introduced an increased proportion of Latvian-language

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<sup>8</sup> It should be noted, that the term Russian is here used with the regard of use of Russian language as the main language in the educational system.

curricula that provoked strong opposition among the Russian-speaking population. The Russian government has also condemned the educational program and expressed support to the protestors (Izvestija, 2002a).

This reaction can be incorporated in the Russian foreign policy strategy presented after Vladimir Putin became a President in late 1999. It stated "respect for Russia's interests, including the fundamental issue of the rights of Russian speaking residents" was "a mandatory prerequisite" for improving bilateral relations (NUPI report, 2000).<sup>9</sup> Thus, the defence of the rights of the Russian-speaking population, at least rhetorically, can be considered an expression of Russian determination to consider the minority issues in Latvia as its national interests.

#### 4.4 The NATO problematique

Despite the general, marked improvement in Russia-NATO relations after the attacks on the World Trade Centre and the adoption of the Russia-NATO Council in May 2002, the Russian government continued to voice concerns about aspects of the possible expansion of NATO (Orban, 2008: 61).

Russia has been interested in keeping the status quo in the Baltic region, and NATO enlargement was considered to be taking place at Russia's expense. After an official invitation to join NATO came at the meeting in Prague in November 2002, the Russian State Duma made a statement that as a result of the entry into NATO by Latvia, Lithuanian, Estonia and Slovenia, which are not parties of Conventional Armed Forces in Europe (CFE Treaty), a "gray zone" in the European space will arise as there will be no restrictions on the deployment of the armed forces of NATO (Ministry of Foreign Affairs of Russia, December 2002). In addition, fears were

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<sup>9</sup> NUPI, Centre for Russia Studies, Chronology of events

<http://www2.nupi.no/cgi-win/Russland/krono.exe?4829>

expressed about future Alliance nuclear deployment in the region. With regard to this concern, an unnamed Russian Defence Ministry official was quoted claiming that: *“We have information that some Baltic heads of state have already expressed their readiness to deploy any type of NATO weapon, including tactical nuclear arms, after their countries join the Alliance”* (Shoumikhin, 2005). Consequently, the operational capacity of Russia’s naval forces in the Baltic Sea could potentially be constrained and its ability to secure air defence over the Baltic Sea further limited. This, in turn, could lead to military vulnerability on the Russian border with the Baltic States.

The Russian concern about military imbalance and the deployment of nuclear arms in the Baltic region has received response from the Latvian Prime Minister who stated that the issue of tactical nuclear deployment had at no point been raised by NATO officials. As well, the Latvian Minister of Foreign Affairs made a statement that Latvia attaches great importance to the norms and obligations of the CFE Treaty and expresses a willingness to accede to the adopted adapted treaty (Associated Press, 2002).

## 4.5 Summary

The rational actor model is the theoretical base for my first hypothesis. The model operates with governments as singular actors; according to its realistic origin the main objective of a state’s foreign policy is its national security interests, defined as power (Orban, 2008:13). Rejecting the transit can be therefore identified as part of Russian strategy to defend its national interests, which means to gain more power in the region. I have proposed that the foreign policy tension between Russia and Latvia--be that NATO membership, or Russian minority problems--could have influenced Russia’s attitude towards Latvia and provoked the reaction to reject the oil transit. The objective of this chapter was therefore to define whether there was a shift in the quality of foreign policy. In order to do it I have defined three important factors in the Latvian – Russian foreign affairs in the time period of 2002-2003: the political

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environment, the tensions around the border treaty and minority issues, and Latvia's NATO application.

Generally, the legacies of history and the controversial interpretation of historical development had elevated political tension between Russia and Latvia. The signing of the border treaty as well as the citizenship policy towards Russian minorities have been main obstacles to constructive co-operation in other fields. Although diplomatic relations had never been openly hostile, foreign policy has been complicated.

In general, the political milieu in Latvia in 2002-2003 was pro-Western and had an uncertain view of the foreign strategy or intentions of the Russian Federation. The applications to NATO and to the EU were therefore perceived as vitally important for Latvian national security. However, Russia had concerns about its military vulnerability, which was caused by the loss of significant seaports and military bases in the Baltic region. The invitation to join NATO that came in 2002 raised concerns about NATO enlargement, as Latvia was not a member of CEF Treaty at that point. This could, therefore, be perceived as a challenge to the military security of Russia. In this context, the termination of the oil transit could be interpreted as a Russian political reaction to domestic politics in Latvia.

However, the negotiations to join the NATO and the EU had been ongoing for several years and Latvian admission to both unions was anticipated as early as 2002 (when the country got its official invitation to join the NATO alliance). Consequently, cutting off the transit would not have any impact on Latvian membership to the NATO. Was the Russian motivation retaliation in this case? What was the rationale for this decision? As far as the foreign policy between these two countries was complicated and no any significant change happened in 2002, the explanation of the decision could be that simple argument that Russia "gave up" on regaining control in the "near neighbourhood" and the stop of oil transit became a culmination of this process. However, one may argue that the use of 'punishment' presupposes that one has already delivered warnings or threats that they would act in this way. However, no threats or warnings were made to terminate the transit arrangement seriously.





## 5. The pluralism of interests and actors

I have so far made a case for that the stop of the oil transit to the port of Ventspils can be understood in terms of realism in foreign policy between Latvia and Russia. As far as the rational actor model operates with the national state as a main *single* actor in the foreign policy and places the national security interests as its top priority, the main attitude was devoted to the Russian and Latvian foreign policy making. I will now take a quite different perspective and will examine whether *the transit break could be generated by the conflict of interests and policies between multiple sub-national actors in Latvia*, as my second hypothesis does suggest. The basic difference from the rational actor model will be the idea that the national state decision-making does not reflect the actions of a single national actor, which is determined to defence national security interests, but rather the myriad of interests engendered by the bargaining between various sub-national actors.

Allison's pluralistic model is used as a basement for my second hypothesis, but it is necessary to underline that the model is modified. While Allison implicates that the multistructuralism of the state apparatus consists of either the organizational structures or key politicians and single officials, I will focus on the interplay between national state officials and oil business actors. The reason for this is that the main actors in the oil transit business in Latvia are the transit companies, not the Latvian state and energy institutions. The state has played a significant role when it came to regulation of tariffs and was a main guarantor for the legitimacy of the transit route as the transit agreement was signed between Russian and Latvian governments.

Nevertheless, the oil transit companies are the main operators of the transit and therefore can be understood as main actors in the Latvian transit sector. Moreover, several research studies have pointed out the existence of particular influence of economic groups on political decision-making in Latvia (Reed, 2002: 3). More concrete, this influence is shared between two economic groups: the oil transit port of Ventspils and its mayor Aivars Lembergs on the one hand, and the Ave Lat economic

group headed by ex-Prime Minister Andris Skele on the other. Both groups seem to have significant influence on the political decision-making process (Reed, 2002: 6). The extent of this influence and its impact on the transit issues will be discussed more explicitly in this chapter.

While the oil transit was interpreted as a national security issue in my first hypothesis, the second hypotheses uses a narrower meaning. The oil transit is relied on as an instrument of power maximization between the oil companies or/and the Latvian government. It is now not the instrument in the foreign policy between Russia and Latvia, but, primarily, an important sector of national economy; therefore, the term of power is related with economical gains and financial profit on the domestic level.

The principle of rationality is also important in this hypothesis. I have already discussed the rationality in the theoretical chapter, but some general assumptions seem to be appropriate to mention again. The principle of rational behaviour can be shortly summed up as the action taken under the circumstances of compliance between one's means and goals (Underdal, 1984). Consequently, it will be necessary to identify the goals of the transit companies and the Latvian state and the options that have been available to achieve these goals. Therefore, I will start the chapter with the description of the structure of the transit business in Latvia and the tariffs, as these two factors form the ground in the transit environment. I will then turn to the relation between the Latvian government and the transit companies in order to find out whether these have had disparities in interests and options. Furthermore, in order to identify whether the hypothesis is viable, it will be necessary to reveal the qualitative shift or differentiation in the transitional conditions before and in the time period around the break. If such a change does exist, it will allow us to implicate that the hypothesis may have a valid explanatory factor.

## 5.1 Oil transit before 2003. Vertical structure/horizontal conflict lines

### 5.1.1 The ownership structure

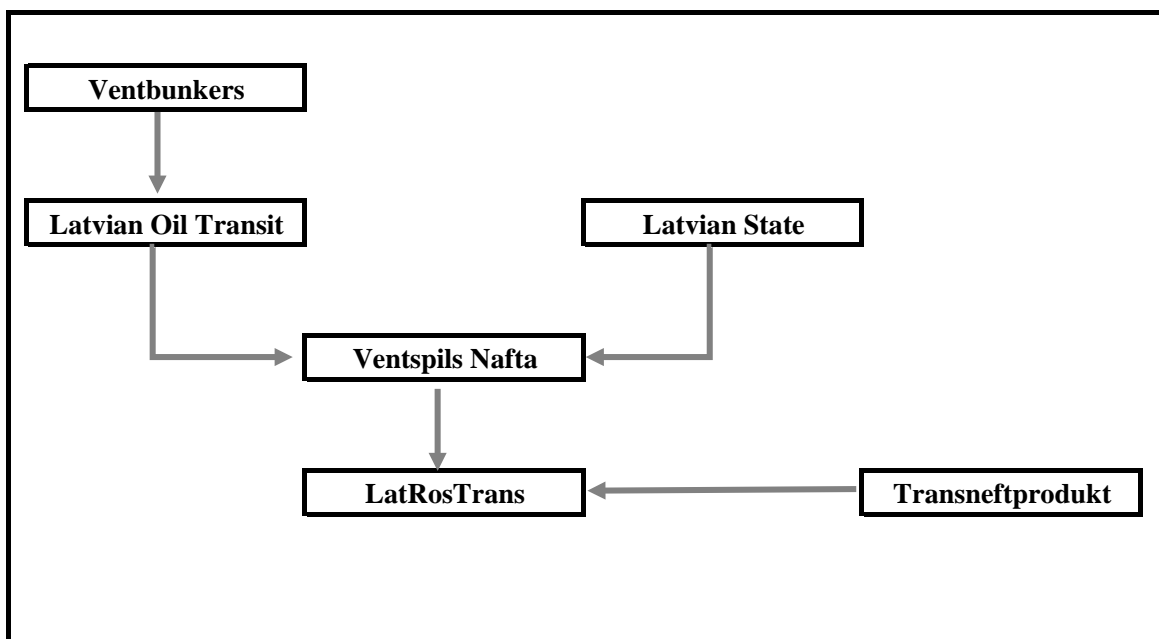
As was mentioned previously, the break of the USSR has created new environment in the transit sector, with new actors and new rules to play. The seaport of Ventspils, the largest ice-free seaport on the Baltic Sea remained Russia's main outlet for crude and refined oil through the 1990s. With the re-gained independence, Latvia proclaimed all enterprises that were located on its territory to be its national property. This led to some disagreements with the Russian side, which was worried about the future of its oil exports through the Baltic ports and the maintenance of the Polotsk-Ventspils pipeline system. Latvian-Russian joint venture LatRosTrans was established to supervise the pipeline and provided technical maintenance (Spruds, 2001: 7).

On the Latvian side, the transit network has been represented by Ventspils Nafta (VN), Ventspils Bunkers (Ventbunkers), LatRosTrans and Latvian Oil Transit (LOT). All these companies are closely interconnected. VN is owned by LOT, the Latvian State and several private actors. It is worth to note that LOT is owned by companies that are themselves owned by offshore shareholders, meaning that a large share of oil transit profits goes untaxed. The Mayor of Ventspils, Aivars Lembergs, who has also been a President of Latvian Transit Business Association,<sup>10</sup> has been one of the shareholders in LOT. These ownership patterns allow us to consider the organizational structure of transit sector as a vertical one, which is illustrated in Figure 1. Furthermore, the board of the largest LOT's shareholder, Ventbunkers, has included two children of Aivars Lembergs, Liga and Anri Lembergs, making this family a major actor in the Latvian oil establishment (Spruds, 2001: 7).

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<sup>10</sup> Latvian Transit Business Association was founded in 1994 and unites 30 transit sector companies and institutions, including port authorities of Ventspils and Ventspils Nafta.

On the Russian side, the main actor has been the state-owned pipeline monopoly, Transneft. The main oil exporters have been Russian oil giants, Yukos and Lukoil (Liuhto, 2003: 10). Thus, the Ventspils Nafta and Transneft have been the main operators of the transit, as far as Transneft is controlling the pipeline system in Russia and Ventspils Nafta has been the only company that got the operation of the oil in Ventspils. Yukos and Lukoil, therewith, have been the main exporters that used the Ventspils facility. Moreover, Lat RosTrans is owned by Ventspils Nafta (66%) and Transneftprodukt, the affiliate of Russian Transneft.



**Figure 1. The vertical structure of Latvian oil transit business**

### 5.1.2 The tariffs

Since 1999, the main partners in crude oil transit were Russian Lukoil, Sidanko, TNK, Tatneft, Bashneft and Yukos. Lukoil and Yukos has been main competitors for the Ventspils export facility, when the last one had by 2002 got the largest part in the transit, standing for 30% of VN's total export volume (Kommersant, 2004).

The oil transit tariff policy has been sensitive to the growing competitiveness among the Baltic seaports. The main rivals for Ventspils are the Butinge terminal in

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Lithuania and the seaport of Novorossiysk on the southern route of Russian transit. As a VN's Technologies Director, Genady Shevtsov has pointed out: "The price is the main factor today. A good level of service and a good price will attract a client". (The Baltic Course, 2002). The transit tariffs have been reduced from USD 5.5 to USD 4.7 pr ton in 2000. However, they have been described as the main obstacle to the further transit of Russian oil, as Lukoil's Baltija board chairman, Haim Kogan has expressed: "Oil transshipment tariff is 0.85-1.80 U.S. dollars in Amsterdam, 4 U.S. dollars in Primorsk, 3.5 U.S. dollars in Novosibirsk and 4.7 USA dollars in Ventspils. I suppose the tariff is one of the highest in the world" (The Baltic Course, 2002).

I have so far presented an overview of the transit structure and the development in the tariff policy in Latvia. The organisation of the transit business can be understood as a vertical one and has a closely interconnected structure. The tariffs on the oil transit have been seen as a main obstacle from the Russian side and the tariff policy has been sensitive to the competition from other Baltic seaports. I will now turn to the relation between the Latvian government and transit's main operator, Ventspils Nafta. The focus will be on the positions these two parts have had in the transit sector.

### **5.1.3 The relations between private oil companies and the Latvian government**

According to business surveys carried out by the World Bank in 1999-2000, Latvia experiences a particularly high level of what the Bank terms "state capture": "actions of individuals, groups or firms both in the public and private sectors to influence the formation of laws, regulations, decrees and other Government policies to their own advantage as a result of the illicit and non-transparent provision of private benefits to public officials."<sup>11</sup> As far as oil transit is considered as a vitally important sector for Latvian economy, the companies within it have been traditionally strong at lobbying their interests for the government. Ventspils Nafta has been a dominating actor in the

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<sup>11</sup> World Bank, *Anticorruption in Transition: a Contribution to the Policy Debate*, p. xv.

oil transit business and its influence on the Latvian politics can be traced through the participation in the formation of governments and political parties (Reed, 2002:6).

What can indicate such participation?

For the first, Aivars Lembergs, the operational head of Ventspils Nafta, has participated in all consultations about the government since 1998, despite his official political passivity. Lembergs has been a key supporter for the Union of Green and Farmers, a small political party with no significant activities at national level. However, the strength of this party had been its ability to join the governing coalitions, where it has been used as a necessary and effective component in opposition to the Skele`s headed People`s Party. Ventspils Nafta has been also a donor to the largest Latvian party, the Latvia`s Way, that has been a member of all coalitions` governments until 2002. The presence of Lembergs in the consultations about the government coalitions has been officially commented as a necessary mean to avoid the “infighting of economic groups” <sup>12</sup>(Reed, 2002: 5).

For the second, the intertwining of Ventspils business interests with national politics in Latvia has gone hand-in-hand with the nature of political party funding practices. Detailed monitoring of election campaign finance by local NGO`s has provided strong indications of covert financing of some political parties by business interests, Ventspils Nafta included. Notably, that the incentives and ability of economic groups to influence political parties through financing have been conditioned by the factors that are linked to particular circumstances in the their business development (Reed, 2002: 6-7)

The privatization of Ventspils Nafta can surge as an example of this tendency. VN was partially privatized in 1997, resulting in an enterprise where 44 % of shares are owned by the Latvian State. Despite this fact, government`s ability to influence decisions made at VN has been almost entirely negligible. A confidential shareholder agreement

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<sup>12</sup> Ave Lat, headed by Andris Skele from the People`s Party and Aivars Lembergs from Ventspils Nafta

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has disabled the Latvian State to participate in distribution of profits and has obliged it to vote similarly to the co-shareholder, the Latvian Oil Transit (Diena, 2003a). For instance, when the Russian Lukoil expressed a desire to privatise the state share in VN in 1998 it has experienced a Latvian standoff. The refusal to let Russian oil companies to join the privatisation process of VN was mainly commentated as inconsistencies in price (Izvestija, 2003). It is important to notice that the Latvian government and the VN had had, at least officially, similar positions in this issue, as Lembergs and other smaller shareholders has publically approved state decision not to sell state shares to any Russian oil company.

Another important aspect is related to the degree of Latvian confidence that the Russian oil companies will use Ventspils as its main Baltic facility. The Latvian oil companies have constantly expressed their security that the Russian oil producers are dependent on the Latvian transit route and the position of Ventspils is secured as one of the most optimal choices of the oil export to the Western Europe (The Baltic Course, 2001). However, this confidence was based on a wrong calculation. Given that the Latvian oil business was aware of the growing Primorsk facility, the rational value-maximizing action would be the one that would make Ventspils even more attractive for the Russian companies. The privatisation of the Ventspils Nafta could be used for that purpose, and the Russian side has pointed out that they will choose those ports that have Russian capital (Telegraph, 2002a). Thus, the Latvian actors have had a significant instrument that gave them a relative freedom to act according to their own interests and this freedom to act could affect the oil transit in whole.

I have so far described the overall picture of the relations between the Latvian state and Ventspils oil environment, mainly using VN as an example. The relations between the national government and the oil companies have two sides. On the one hand, the influence of the oil companies on the national politics can be revealed by examining the financing procedures by the political parties in the governmental coalitions. However very little concrete evidence on mechanisms of state capture to back up the NGO`s surveys is available as the national government has repeatedly

highlighted the importance of the oil transit business in the national economy. On the other hand, the state's ability to influence decisions made at VN has been strongly limited by a confidential shareholder agreement that disabled the state to participate in the distribution of profits. The Ventspils Nafta's tax contribution to the national budget has also raised disputes. The main reason to this was the fact that Ventspils Nafta is a part of a Latvian Oil Transit, which is partly registered at Cyprus and a significant part of their profits has passed taxification (Diena, 2003a).

Although, when it comes to the transit strategy with Russia, both sides enjoyed agreement about the decision to exclude Russian oil interests from privatisation of Ventspils Nafta. Let me now turn to the developments in the oil transit in Latvia in 2002. Three main events has shaped the transit sector, the elections of 2002 and Russian oil business's interest to privatize state shares in VN and the internal conflicts in VN.

## 5.2 The development of Latvian oil transit sector in 2002-2003

### 5.2.1 From state capture to the anti-corruption campaign of New Era Party

As was mentioned previously, the elections of 2002 were won by a new political party, New Era, which ran on a mainly anti-corruption election program and got 26 of 100 seats in the Latvian Parliament. Indeed, the political institutions and laws regulating the party financing system were not changed since the readoption of the 1922 Constitution. This resulted in a highly opaque and liberal institutional framework for controlling party finances. Consequently, both the World Bank and the European Commission came with comments on the corruptive element in Latvian national politics and the application for the EU membership obliged Latvia to moderate its anti-corruption legislation. The Repse government has promised a new era of increased transparency and reform in the party funding system, making the



financing channels more traceable. However, this determination was largely depended on the stability of the coalition and internal cohesion of the four coalition parties, which it did not manage to achieve, due in part to accusation in corrupt real estate purchases for the Prime Minister Repse himself (Brynhildsbakken, 2003).

I have already mentioned that two main economic groups, the Ave Lat group and Andris Skele, who is also the founder of People's Party and the Ventspils Nafta group with Aivars Lembergs ahead, have shared the influence on the national politics. The elections of 2002 have weakened the People's Party and the position of Andris Skele as he joined the governmental opposition. As the latest political debates have revealed, Skele has been under the political press both from Repse and Lembergs, as these two have had an agreement on specific economic interests in 2002 (Diena, 2008). Either Repse or Lembergs have not commented what these interests may contain, but the privatisation of VN has been a central issue in the domestic economic policy-making under the Repse government.

To sum up, the elections of 2002 has had an anti-corruptive agenda and the Prime Minister Repse has proclaimed the battle against state corruption as the main domestic objective. As time has shown this battle was hard to win as Repse suffered himself from the accusation in corruption. The elections of 2002 has also weakened the other political party, headed by the Ave Lat economic group chief, Andris Skele, as this party formed the opposition to the New Era government.

I will now turn to the Russian interests in the transit business in Latvia and the privatisation of the Ventspils Nafta as an expression of such interests.

### **5.2.2 Russian interests in Latvian oil transit sector**

Russian capital in Latvian oil sector has been rather limited. The only place with significant Russian share is a joint venture LatRosTrans, which was established because of agreement between Russian and Latvian governments in June 1993. The company owns the pipeline and Russian and Latvian side had shared the

responsibility of its technical maintenance. The Russian capital in LatRosTrans can be considered as a manifestation of Russian interests in the Latvian oil sector. Moreover, Russian investment sources were sought for further development and implementation of transit project, such as Western Pipeline System that was aimed to increase the flow of oil to Ventspils Nafta. The largest Russian oil companies, Lukoil and Yukos, were contemplating participation in this project (Spruds, 2001: 7).

Furthermore, Lukoil made an attempt to privatize the state shares in Ventspils Nafta, but this attempt gave no result. The reluctance to allow Russian capital to enter the privatisation of Ventspils Nafta has contributed to the transformation of Russian oil companies' long-term economic calculations and investments plans. As Transneft's vice-president, Sergej Grigorjev has pointed out: "Russia will choose those seaports that have Russian capital. To invest in pipeline modernisation in Ventspils will serve only Latvian oil business interests, not ours. We have offered 140 million U.S dollars that could be used in the modernisation of the pipeline in Ventspils port in turn of VN state shares, but Lembergs demanded 200 million U.S. dollars" (Telegraph, 2002a). Throughout 2002, Transneft has gradually decreased the oil flow to Ventspils Nafta, resulting to 13.8 million ton in 2002 from 22.3 million ton in 2001. The official explanation of the reduced oil flow has been the necessity to provide enough oil to the Russian port of Primorsk.

### 5.3 Summary: yes – to Russian transit, no – to Russian privatisation

To sum up, I have made a description of transit conditions before 2003 in a hope to find shift in either national politics or the interests of the oil companies and the Latvian state. However, the established patterns of oil transit business have been stable throughout beginning of 2000. The tariffs on oil transit were stable and even reduced in 2002, as Ventspils Nafta experienced growing competitiveness from the other Baltic seaports.

I have also made a description of ownership in oil transit business by highlighting the vertical structure and therefore a hierarchism of power. The relation between national political elite and the oil companies was discussed as a matter of state capture in Latvia, where business interests influence national politics through financing political parties and lobbying top-politicians.

The findings can be shortly summarized as following:

- The Latvian state and Ventspils Nafta had denied Russian capital to enter privatisation of VN, but both sides wanted to have the transit of Russian oil.
- The Latvian state suffered economically because of confidential share agreement that nullified its ability to participate in the distribution of profit.
- The influence of Ventspils Nafta on the national political life can be traced through the financing the coalition government party, the Union of Green and Farmers and Lemberg`s participation in coalition negotiations. This can be understood as a continuation of established form of “state capture” system in Latvia.
- The elections of 2002 and Repse`s political ambition to minimize the influence of particular business structures on state policy-making has shaped the relation between Ventspils oil companies and the government.
- That Ventspils Nafta has rejected Transneft`s proposal to invest significantly in modernisation of the pipeline in the seaport region, since the condition was to let Transneft to join the privatization of VN.

The privatisation of the state share in VN can be understood as the most significant feature in the Latvian-Russian transit relations in 2002. The capacity to deny Russian capital in the privatisation of VN underlines the main proposition that the Latvian sub national actors, the Latvian government and the oil establishment in Ventspils, have had control over the facility that was strongly desired by the Russian side.

Consequently, this decision to keep the Russian capital out of VN could have had a spillover effect to the Russian side. Another central observation was that the Latvian oil establishment had not considered the possibility to lose the oil transit, as the rational actors should have done. Both the state authorities and VN was confident that Russia will keep using Ventspils, because it was economically beneficially. This calculation turned to be a faulty one.



## **6. State power consolidation in the Russian oil sector**

My third hypothesis suggests that the disruption in oil transit can be understood as a consequence of changes in Russian domestic energy policy. There have been clear indicators of increasing state control over the Russian energy sector in general and oil industry in particular (Orban, 2008:64). Furthermore, I understand this shift as a necessary condition to achieve particular long-term goal, namely, to strengthen Russia's economy, which can help to restore its international position. This means that the transit was to be stopped independently of what country it was going through. The focus has, therefore, moved on the Russian state politics in the energy sector.

This chapter does not address the whole energy sector, only the factors that are directly linked to oil transit and only in the Baltic region. Moreover, the events this essay is focused on have taken place near the beginning phase of a process for an increase of state control over the Russian energy sector. The case of Ventspils can be therefore addressed as an example of Russian strategy to avoid transit routes and develop its own transit facilities as no Russian interest to obtain Ventspils Nafta was expressed since 2003. I will start the chapter with some core theoretical positions and will turn to the general change in Russian energy strategy after President Putin came to power. The solution to stop using Ventspils facility will be examined in the logics of general determination to avoid transit routes.

### **6.1 Neoclassical realism and the model of internal/external polarity**

According to neoclassical realism, foreign policy decisions must be explained by taking domestic politics and the structure of the international system into consideration. Under which conditions the state prefer its domestic relative to external interests is a central question in Alons's model of external/internal polarity. The

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model combines the strength of the domestic structure approach and the strengths or realist theories. It builds upon the argument that the more capabilities (political, economic and ideological) the state has, the better it will be able to ensure its survival and strengthen its international position (Alons, 2007:219). It also claims that the political interest of the state comes prior to its economic and ideological aims. Furthermore, the distribution of power is a central element in this model. On the domestic level, this implies that the centralization of power (high internal polarity) enables states to act more unconditionally and independently on the international arena, while the decentralization of power obliges to take into consideration prepositions of several parties and thus limits freedom to act. It also means that the state will attach more importance to its external interests relative to its internal interests (Alons, 2007:220).

Thus, how would this model explain the oil transit break to Ventspils? As my hypothesis suggests, the transit break is an expression of general Russian wish to avoid third parties in transit routes; in other words, domestic politics have influenced the decision to stop the transit. This is linked to the next perception, that the oil industry is important for Russian economy, which in turn is important in achieving the long-term goal, e.g. to restore Russia's power position on the international level. Therefore, according to Alons's model, the high internal polarity will make it better for Russia to take account of its external interests. It also predicts that the economic and ideological interests will be dominating in the preferences made by the government. As Russian political system in 2002-2003 can be described as a centralised one, with the President and the prime minister belonging to the same political party (The United Russia) and a low level of institutionalisation (Rose&Munro, 2002: 41), I will go directly to the power distribution in the oil industry by examining the interests and capabilities of the private oil companies relative to the Russian state.

Neoclassical realists underline the importance of what perception of state role in the international system the political leadership has. Therefore, I will also clarify what Putin's vision of Russia in 2002-2003 was and how his strategy to realize this vision

was. The power distribution on the international arena will be also described as the external polarity influences on the state preferences (Alons, 2007:216).

## 6.2 The internal polarity

### 6.2.1 The interests of the Russian oil companies

Russian oil industry is increasingly important player in the global energy market and is today the second largest oil producer in the world (Woehrel, 2009:1). In the early 2000s, it consisted of several major oil producers, such as Lukoil, Surgut, Yukos and Sibneft.

To begin with, in the 1990s, the Russian state did not have any large stake in Russian oil production and the oil companies enjoyed freedom from state management. After demonopolization and liberalization of the oil prices in the early 1990s, the oil enterprises maximised their profits by expanding the oil production and moving most of the profits to affiliated trading companies (Åslund, 2006:322). The largest part of the oil exports (98%) were the European markets and the export routes were primarily the trunk pipelines (Milov et al 2006:294). Operational oil export routes were physically locked to continental Europe, which underlines the necessity of transit corridors and joint management of the pipelines.

In 2002, in order to diversify the transit routes, Yukos, Lukoil, Sibneft and TNK announced a plan to build an oil pipeline from Western Siberia to the seaport of Murmansk. The project was to be privately financed and operated, as the companies saw an opportunity to create a new export route and increase their oil production (Orban, 2008:64). If this pipeline was built, it would control 25-30% of Russian crude oil transport and would have broken the Russians state's monopoly over crude oil transport, one of its primary sources of revenue. Moreover, as was later known, Yukos was conducting negotiations to sell a large stake of the company to American interests, the manoeuvre, which could have made the company even more



independent from the Russian authorities. As reflected in later developments (state accusation of large-scale tax evasion and later bankruptcy of Yukos), it is quite certain that these actions were creating deep concerns in the Russian government (Orban, 2008:64).

To sum up, after the collapse of the centralized Soviet system, the oil companies experienced a decade of liberalization and high profits. The state ownership was rather limited as only 24% of oil producing enterprises was under state control in 2003 (Hanson, 2009:14). The main importers of Russian oil have been the European countries, and the export was carried out by trunk pipelines, that put certain limitation on the oil export. In order to diversify the export routes the major oil companies had plans to build a new pipeline system that would have broken the Transneft's monopoly over pipeline transportation. Yukos's increasing independence from state control and the planned project of a new pipeline were important developments as they make a preface to the transit events that happened in the beginning of 2003. In the next part, I will focus on the state strategy in the oil sector.

### **6.2.2 The interests of the Russian state: from tanks to tankers**

Russian energy policy has been through a significant transformation after President Vladimir Putin placed a considerable emphasis on promoting Russian economic interests as an important feature of the foreign policy. This was implicit in both his essay "Russia on the Threshold of the Millennium" and in the Foreign Strategy Concept of 2000. Calling Russia for "a rich country of poor people", Putin has emphasised the role of the state as a "night watchman" and the principle engine of the economic growth. Consequently, the main task of the state should be "defending the market from illegitimate interference, both bureaucratic and criminal" (Putin, 1999). As the energy sector is vitally important for the Russian economy (mostly because that it is the main contributor to the national budget), the current energy policy has been formed out of a national security perspective (Milov et al, 2006: 286). Moreover, one may argue that the energy resources have replaced the power base for the current

Russian state. It has transformed itself from a military superpower to an energy superpower, and realizing the vital importance of energetics, Putin has taken several steps in increasing state control over energy industry.

Particularly, in the petroleum industry, the result of the new course in national security strategy is reflected by a shift from the liberal model of 1990s, which emphasised the importance of private privatisation of the energy assets, to the growing state control over energy industry. Åslund describes this particular tendency as a model of *state capitalism* that basically means that the state should have at least 51% of the stake in the largest energy companies (Åslund, 2006: 324). However, the ownership is not the only aspect that should be controlled by the state authorities. Oil industry includes productions assets, transportation routes and transit facilities to the export partners. By controlling more elements in this chain, the state could gained full control in the oil industry. Firstly, transportation and transit is controlled by Transneft, which controls transportation and is able to determinate production quotas for the oil companies. Secondly, the state tax policy over oil production was reinforced as well as the use of the legislation controlling the environmental aspect of this industry (Woehrel, 2009: 3-4). In this way, the state has readjusted its energy policies concerning the production and the transit of Russian oil.

To sum up, the presidency of Valdimir Putin has changed the Russian economic strategy in general and the oil industry in particular. The oil companies were privatized in the beginning of 1990s and enjoyed liberal export policies that gave them an opportunity to achieve high production profits. This has changed in the early 2000s and the tendancy of growing state control in the oil sector can be seen in the transit policy.

### **6.2.3 The transit policy of the Russian state**

A core issue in the current energy strategy is that Russia does not want to remain dependent on third parties for transit to consumer markets (Larsson, 2006: 173). As early as 1996, Russian Minister for Fuel and Energy Pyotr Rodionov pointed out that,

“this is nonsense that Russia, which possesses an enormous export potential and the means to build its own ports on the Baltic coast, has to orient itself towards Ventspils” (Spruds, 2001: 5). Already at the beginning of the 1990s, Russia enhanced the necessity of developing of its own transit infrastructure in the Baltic region. The Russian government made a decision to carry out the Baltic Pipeline System project, aiming to link Timano- Pechora and West Siberian oil regions with prospective port terminals on the Baltic Sea. As a part of Baltic Pipeline Project, the port of Primorsk began to function in 2001. Initially its output was estimated to 12 million tons per year, but in 2003 Transneft increased it to 30 million tons (Liuhto, 2003: 31). The tendency with the oil transit from the port of Ventspils, however, was the opposite. This position was explicitly distinctive from the interests of the private oil companies.

To illustrate the point one can remember the fact that when the Russian government took a decision to stop use the Ventspils facility in 2003, and Transneft cut off all shipments, five major Russian companies (Lukoil, Yukos, Surgutneftegaz, Tyumen and Rosneft Produkt) raised their objections. Their official letter to Moscow, containing a strong appeal to re-open the oil pipeline to Ventspils, did not get any attention (Smith, 2003: 3). Furthermore, Transneft diverted the oil shipments to its own Baltic Pipeline System and the seaport of Primorsk. The companies that continued to use Ventspils had to re-orientate their export routes and use more expensive railway transit. All this happened in the late 2002 and 2003, the years when the output of crude oil production rose to its peak, so that the timing of Ventspils blockade was economically destructive. Later on, when the re-orientation to the railway was complete, the state had increased the transport fees, making the railway export even more unprofitable (Liuhto, 2003: 31). It seems that the logical explanation of these actions is the persistent intention to force the oil companies to avoid non-Russian transit routes and use Primorsk facility instead.

According to Alons model, the power relation seems to be crucial in the relation between the Russian state and the private oil companies. As far as the state controlled the pipelines, it was able to control the quotas of the exported oil and the routes the

companies could use, by this strengthening its power in the oil industry. It is worth noting, that the state has also been arguing for the necessity of transit diversification. Nevertheless, contrary to the private enterprises that were more flexible in choosing foreign seaports and pipeline systems, it favoured using exclusively Russian transit assets. Moreover, these assets must be controlled by the state Transneft. Consequently, the range of options for the private oil companies was significantly limited.

The other aspect of the control over the pipeline is the economic pressure it creates, which is sufficient to contribute to change in the companies' strategy. An example is the position of the Lukoil, Russian second largest oil company, after Yukos. The company has a 10 % share that is owned by ConocoPhillips and has been relatively independent in its business development. However, Lukoil's president, Vagit Alekperov, has been particularly clear in his statement, that Lukoil should be considered as a national Russian company, "that above all profits work in order to build a contemporary highly developed economy, a great power, Russia." (Smith, 2003: 2).

Summa summarium, it is likely that Russia will continue to reduce the dependency on oil transit via the Baltic States. As Liuhto (2003:44) argues, the role of the Baltic ports will diminish, even if Transneft or another Russian oil actor would get control over VN.

### 6.3 The external polarity

The external polarity relates to the degree to which power is concentrated within the international system. External polarity increases as power is more concentrated, or with other words is distributed more unequally (Alons, 2007:219). Furthermore, Waltz argues that inequality of states contributes to peace and stability, using bipolar system as an example of international stability (Alons 2007: 219). Hence, the stability within the international system will affect the importance a state attaches to its

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political, economic or ideological interests. Shortly, as the stability increases, long term benefits will be valued higher and the state will attach value to its economic and ideological interests. Finally, the lower the external polarity, the more importance a state will give to its external interests relative to its internal interests (Alons, 2007:220) Considering this, what was the power distribution and what was the perception of the Russian leadership about power distribution in the beginning of 2000s?

The break of the communist system in Europe in the early 1990s has also broken the system of bipolarity, where the two superpowers, USA and USSR had been balancing each other for 45 years. There is no agreement on what kind of system the world had in the years following the end of the Cold War (Alons, 2007:223). Was, for instance, India getting to be a pole? Can we consider Japan, a military dwarf, a polar power? How many poles are there today? Some scholars argue that the system is on the way to become multipolar with middle powers getting more influence, while others argue it is getting to be a unipolar, with the USA as hegemony. What the scholars do agree on is the fact that this period is a period of transition for the international order (Østerud, 2001: 345-346).

The 1990s was a period of transition for the international system that involved a high degree of uncertainty and instability for most states, which closely resembles what Alons identifies as low internal polarity (Alons, 2007:223). Russia was obviously weak in this period, facing challenges both at the domestic level, such as the economic crisis in 1998, and on the international level, as NATO was enlarging eastward. However, the new presidency in 2000 has changed the political and economic agenda of the country, when President Putin began to consolidate state power (Orban, 2008:64). Putin's international aspiration was to restore Russia's influence and the way to do it was by strengthening its national economy. In order to make Russia a great power again, Putin believed it must be an economic partner of the European countries, a reliable partner, willing to compromise. By this, he foresaw a world where the political influence will be determined by a country's economic

power, not its military power (Orban, 2008:63-64). Therefore, “the foreign policy must be subordinated to domestic economic interests” (Putin, 2002). Despite improving relations with USA, the general principle in foreign policy can be shortly described by a quotation of Deputy Chairman of the Defence Committee of the State Duma in 1999, Aleksei Arbatov: “counterbalancing American aspirations for a global monopoly, the concept of multipolarity as the best expression of country’s national interests has received strong support in Russia” (Kratochvil, 2002:8).

How the Russian leadership understood the distribution of power on the international arena is an important factor, according to neoclassical realism. The war in Iraq has shown that the United States could act even though the Security Council of the United Nation did not approve the military action; this can, in turn, be interpreted as evidence of unipolarity, where the USA could act on its own. Although the Iraqi war challenged the internal co-operation in NATO, it was still steady in its determination to enlarge with the Baltic States (Freedman in Baylis et al, 2007:365-368).

Overall, the uncertainty on the international arena that the early 2000s can be described as, according to Alons resembles to the low external polarity (Alons, 2007: 223). This means that Russia would have paid more attention to its external interests and tried to secure its international position. However, this clash with the actual foreign policy outcomes and the rhetoric that came from President Putin.<sup>13</sup> He insisted that the foreign policy should be subordinated to the domestic long-term economic interests, which if we apply the model of internal/external polarity, would mean that Russia perceived the international system as more stable and unipolar than multipolar (Rumer, 2007: 24-26).

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<sup>13</sup> As was mentioned above, Putin has instead that “the foreign policy must be subordinated to domestic economic interests” (Putin in *Commersant*, 2002)

## 6.4 Summary

In this chapter, I have focused on the relation between the Russian state and the private oil companies. The argumentation for this hypothesis was based on the model of internal/external polarity and neoclassical realism. Neoclassical realism highlights that the foreign policy outcomes should be seen as a result of international constraints and domestic incentives. The model was used to identify when, under what conditions, the state attaches more attention to its domestic relative to external interests.

The relationship between the state and the private oil companies was used as an example of power consolidation in the oil industry. The transport issues seemed to be a major question of disagreement between the Russian state and some private companies and were used as a tool to get more control over oil companies. Although, both sides admit the necessity of the diversification of the transit routes, their strategy has been critically different. The oil companies found themselves directly dependent on the state Transneft, the factor that had put limitations on their export policies. This situation seemed to be strengthening as the state had turned down Yukos attempt to build its own pipeline system.

The hypothesis was formulated on the idea that the transit was to be stopped because Russia tries to circumvent the third parties in transit routes by any means. With other words, the stop cannot be directly connected with Latvia as a state or an economic partner. The timing when Transneft closed the pipeline to Ventspils may strengthen this idea. The year 2003 was a peak year for Russian crude oil production and the necessity to use more expensive and less effective railway routes has contributed to the decline in revenues. However, the state had put aside what it has called as short-term profit seeking goals of the oil companies, and had focused on the securing of the state monopoly over the pipeline system and the use of national transit assets as necessary means for sustainable development of national economy.

The power consolidation in the oil industry was increasing in 2002, which would mean that Russia was increasing its capabilities for effective appearance on the international arena. Nevertheless, President Putin has on several occasions highlighted the necessity to subordinate the foreign policy to long-term economic interests of Russia (Oldberg et al, 2005: 49-50). This idea is central in my hypothesis, which says that the transit stop is a consequence of general principle to avoid third parties in the transit route and by this increasing power of the state owned Transneft. This, in turn, strengthens the assumption that the Russian leadership perceives the international system as a stable system, where Russia was relatively weak and the only way to restore its power is to get a strong economy. Russia wanted a multipolar world, where it could take a place of one of the poles, but the pragmatic foreign policy may indicate that it saw the international community more unipolar, than multipolar.





## 7. The concluding discussion

The main objective of this thesis was to find a reasonable explanation of the Russian decision to turn down the oil transit to Latvia. Three hypotheses were made and each of them has been analysed according to the information that was available. In this chapter, I will summarize the main points in the hypotheses, taking into consideration strong and weak explanatory ability of each of them. I will also discuss the methodological aspect of this paper, pointing out what advantages and disadvantages the case study design has. Additionally, some remarks about data sources will be made, as this is important for the reliability of my thesis.

### 7.1 The methodological challenges and the case study design

The biggest challenge in writing this thesis has been getting the relevant documents. The transit issue is a matter of great importance in the Latvian economy, so that the main actors that have been involved in the oil transit in 2002-2003 are mainly so-called “Latvian oil oligarchs”. My interest for these events has been met with reluctance and even suspicion<sup>14</sup>. After contacting Ventspils Nafta and getting a clear response that they do not share any information on this issue and that everything that is meant for the public interest is available on the Internet, I turned to the state authorities and contacted the Ministry of Economics and the Foreign Economic Relations Department. None of these would help me with any data, giving the same advice to use the Internet. However, there are no formal reports or literature that has analysed the transit termination directly that was available. Thus, the main sources used in this thesis are the articles and reports concerning either the foreign policy

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<sup>14</sup> I have been lucky enough to have some acquaintances in the Latvian Parliament and could get an interview with the Andris Linuzs, the vice president of VN in 2002-2003. At the same time, I was more unlucky, because none of these sources was willing to share any kind of information with me, referring that everything that they could have said was have said to the Latvian public prosecution.

between Russia and Latvia or the Russian energy policy in 2002-2003. I have also used official documents available on the Internet sites of the President of the Russian Federation and the official Internet resources of the Latvian Foreign Ministry.

The lack of primary data sources, except the newspaper articles that I have used, can have a damaging effect on the reliability and the external validity of this thesis (King, Keohane and Verba, 1994: 24-25). Therefore, I have been particularly cautious to the articles I have used in my analyses. Furthermore, in order to strengthen validity and avoid bias, I have used source triangulation, using various sources for documents and articles in Latvian, Russian and English languages. Through the whole thesis, I have referred to the sources where the information was drawn from, thus making it verifiable.

Considering internal validity, or the compliance between the study question and selected variables, I mean that my three hypotheses illuminate the case from different perspectives and present different explanation to the event. I do not insist that I have come with the most exhaustive version of the explanation, but I do believe that I have focused on the central aspects of this event.

Overall, this thesis has had an objective to explain why Russia turned down the oil transit to Ventspils and the case study method has been a natural choice. Case study design is appropriate when there is a unique event to investigate (Yin, 2003: 13-14). The main question in this thesis is a “why” question, making it to an explanatory case study. For the best purpose, this method can unite all three traditional purposes: to exploit, to describe and to explain particular phenomena (Gerring, 2004: 342-343). The main advantage of the case study design is that it provides much more detailed information that is available through other methods. On the other side, the value of the case study is measured by the degree to which the incidents that were discussed can be generalized to other situations. Thus, I do not have any ambition to come with any general conclusions, but I do mean that this type of work could be used in a more complex comparative study.

I have applied three different theoretical models to explain why this decision was taken and I will now turn to the discussion of the main findings in my analysis.

## 7.2 The discussion of the findings

During the whole year of the 2002, Russian state monopoly, Transneft, was reducing oil transit to the seaport of Ventspils and, since January 2003, oil transit via the Polotsk – Ventspils pipeline was cut off due to the Russian Government Commission Decision of December 2002 (Regnum, 2003). In order to explain why the oil transit was stopped I decided to focus on the foreign policy relations between Latvia and Russia, the various of interests among the actors on the Latvian side, private as well as state and, finally, on the domestic oil strategy of the Russian state.

### 7.2.1 Hypothesis 1, the Rational Actor Model (RAM) and high politics

Using Allison's rational actor model I have formulated a hypothesis, which says that Russia and Latvia, acting in the best traditions of realism, i.e. defending their core national interests, have made their relation so complicated that this has influenced the transit. With other words, the complexity in the high politics has created bad conditions for the transit of the Russian oil.

Ensuring national security is a fundamental task of Russia's energy policy and a core issue in this policy is transit dependency. Consequently, the transit stop can be seen as a reaction to defend the Russian national interests. What has come from the analysis is that, yes, the relations between Latvia and Russia were complicated and more unfriendly than friendly in 2002-2003, but they have not been crucially worse compared with previous years. The political leadership in Latvia has been pro-European and anti-Russian ever since Latvia got its independence in 1991 and the elections of New Era party in 2002 has been a continuation of the established patterns of politics (Bugajski, 2002)

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The other aspects used in the analysis were the Russian minority issues and the agreement of the border treaty between Russia and Latvia. With the regard to the Russian minority problems in Latvia, the Russian state has on several occasions marked its wariness of the way the Russian language and the Russian-speaking minorities are treated in Latvia. Putin has explicitly expressed that the Russian state considers the position of the Russian-speaking residents in the neighbouring countries as a matter of national security (Putin, 1999). However, the negotiations on the border treaty and the Russian minority status in Latvia represent the long-term issues that dominated foreign politics long before 2002. The only significant change that happened in 2002 is the introduction of Latvian language as a dominating language in the schools that once had Russian as their main teaching language (Weir, 2002). However, it is difficult to believe that Russia could have reacted so strongly on this issue as the transit to Ventspils has been beneficial to the Russian side as well. Moreover, this hypothesis builds on the rational actor model, which implicates that the state is acting rationally. Therefore, the domestic policies over minority status could have influenced the Russian reaction only if Russia saw itself able to change these policies by, for example contributing to the change in the Latvian government making it more Russia-friendly, which in this particular case was not realistic.

Latvian application for NATO was another factor that made the bilateral relations complex and the official invitation to join the alliance in 2002 has shaped the Russian policies in the Baltic region. According to RAM, the main national interest is the national security. By having a NATO country as its direct neighbour, the buffer zone that the Baltic countries were important for, would be gone. This would have destroyed the military balance in the region and the Russian position would be significantly weakened. However, again, the negotiations to join the NATO have lasted for almost a decade and the official invitation that Latvia has got in Prague in 2002 has been their successful finish. What was the motivation behind the Russian decision to turn down the oil transit? To threaten the Latvian state from joining NATO? Many scholars do believe that Russia's reaction to the new NATO enlargement has not been as hostile as many expected (Oldberg et al, 2007: 34). In

October 2001, as Russian-American cooperation on terrorism was moving forward, Putin was saying that if NATO was to continue "becoming more political than military" Russia might reconsider its opposition to enlargement (Baev, 2008: 36). This was hardly an expression of Russian support for enlargement, but it was the strongest signal that Moscow wants to find a way to accommodate a development that it does not like but knows it cannot stop. Consequently, there was no rationalism in cutting off the oil transit with a purpose to threaten. All in all, the transit break has occurred when the Russian-Latvian relations have been bad, but not worse than they used to be and when Latvia was preparing to join NATO. So, that the turn-down can indicate that Russia adjusted its strategic interests in the Baltic region and have "given up" regaining control. Taking into consideration the realistic perspective of the rational actor model, the motivation could be as simple as the wish to "punish". However, this would involve one important element, namely, the threat, that Russia should have come with in the first place, the element, which is absent in the documents that I have used to cover this hypothesis. Thus, the hypothesis is not supported strongly.

### **7.2.2 Hypothesis 2. Pluralism of actors and interests on the Latvian sub-national level**

The second hypothesis suggests that the actions taken by the actors on the Latvian sub-national level could have provoked the decision to turn down the oil transit. The focus has been therefore moved from the high politics on the international level, to the Latvian domestic transit policies. I have pointed out that there have been signs to the "state capture" in Latvian politics, as two main business groups have influenced the political parties and the formation of the coalitional governments. One of these groups, led by the Ventspils chairman, Aivars Lembergs, represents the oil establishment in Latvia. However, because of the great economic importance of the oil transit the involvement of Lembergs in national politics has been commented as a necessary one.

So, how could the policies or interests of the Latvian oil business have influenced the Russian transit? The answer can be found in the privatization process of Ventspils Nafta. This asset has been desirable for the Russian oil companies, Transneft in particular. They have on several occasions expressed the desire to participate in the privatization process of VN, the intention that has been met with no response from the Latvian side. Both the Latvian politicians and the VN main shareholders have been against Russian capital in VN. This strategy was later commented by Transneft's vice-president as an unfortunate one, as the Russian oil business had explicitly expressed the decision to choose those seaports that will accept the Russian capital (Telegraph, 2002a).

The other factors that have been important in the transit issue are the transportation tariffs and the technical maintenance of the pipeline. High tariffs have been presented as one of the many causes to the Russian decision, but my analysis has shown that they were even reduced in 2002, as VN has got to compete with the Lithuanian seaport of Butinge. Another important factor was that the year 2002 was the one with the highest oil prices on the world market, so that the loss of an important export facility has been damaging not only to the Latvian oil business but to the Russian one as well. Was it economically rational of the Russian government under the circumstances of high prices and high demand for the Russian oil to decrease the export capacity of its national companies? The answer is obviously no, as the main Russian companies have reacted with objection against this decision.

All in all, the control over the privatization of VN, the asset that the Russian oil companies were particularly interested in, was the main instrument that could have affected the transit. Indeed, after a set of negotiations, Transneft reconsidered opening the oil flow to Ventspils in the turn of privatization of state holders in Ventspils Nafta by Russian oil companies. However, in March 2003, Repse made an announcement that the privatization of state holders of Ventspils Nafta was not to be expected in 2003. As a result, Russian government urged the contraction of the Russian project,

Baltic pipeline scheme 2, which would increase the capacity of Primorsk to 42 million ton pr year and put a deadlock on Ventspils (Johansson, 2003).

However, this explanation can be criticized for being too simplistic. The oil transit have been beneficial for both parts as the Russian side has had a modern and secure way to export its oil to the world markets and the Latvian oil sector has been important for the Latvian economy. Therefore, the loss of Ventspils has also damaged the Russian oil companies that had to re-orient its transit routes to the more expensive railway method. On the other side, this decision could be taken with the very purpose to weaken the Russian oil companies, a statement that leads us to the third hypothesis.

The main goal objective with this hypothesis was to show that the decision to terminate the transit could be explained by economic, not political factors. It was also important to highlight that the Latvian actors were able to influence this decision by denying Russian Transneft to participate in the privatisation of VN. They had also made wrong perception on how long the Russians will tolerate this denial. However, the analysis has not revealed any sharp change in privatisation process or tariffs, the factor that does not strong the hypothesis.

### **7.2.3 Hypothesis 3. The neoclassical realism and the model of internal/external polarity**

My last hypothesis says that the Russian decision to turn down the oil transit to Ventspils can be embedded in the overall strategy to circumvent the third parties in the transit routes, underlying that internal energy policy can be preferred before foreign policy interests. However, this policy is, in turn, incorporated in the state strategy to gain control over the oil industry, by making them to use national seaports where state owned enterprises have control shares. The decision to prefer national seaports and avoid transnational routes can be embedded in the overall shifting strategy of the Russian foreign policy, which subordinated foreign policy to national economic interests. With other words, the transit stop is a consequence of changes in Russian internal energy policy. Moreover, I have suggested that oil industry is also



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important for the state power in its most classical interpretation. Oil is not only important for the economic strength that can be later used as a toll in foreign policy making, but has a potential for political power within the Russian Federation. The case of Yukos can strengthen this assumption.

In addition, the time aspect has become a matter of great importance in the composing the third hypothesis. This is because the transit break occurred in the very beginning of 2003, while the main re-evaluation of the Russian state policies in the oil industry happened sometime later.<sup>15</sup> Consequently, the developments before 2003 can be understood as a prelude to the main change.

The 1998 default of Russian economy underlined the importance of the economic factors for country's security. The new Russian Foreign Policy and Security Concept endorsed during the leadership of Vladimir Putin in 2000 has revealed an “*economization*” of the Russian foreign policy, thereby reflecting a shift from an explicit geopolitical thinking towards a more geo-economic approach (Spruds, 2001: 29). Russia used to seek global influence, now it seeks a regional one (Jørgensen, 2003: 84). And this influence is achieved by particular economical tools. As Huntington has pointed: “*economic activity is a source to power. It is, indeed, probably the most important source of power, and in the world in which military conflict between major states is unlikely, economic power will be increasingly important in determining the primacy or subordination of states*” (Huntington, 1993: 71). Consequently, the Russian side could have evaluated the relative costs and benefits of the transit stop and chosen the decision that served the national interests in the best possible way. Although we can understand the economic logic behind the transit, to ignore the political premises is unwise.

Neoclassical realism has been used as a theoretical ground for the analysis. The theory argues that the relative distribution of power in the international system through the

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<sup>15</sup> The arrest of Yukos head in 2003, Mikhail Khodorkovsky, has been marked as a turning point in the state policy as it sent a message that the state is strengthening its control over the oil industry.

perception of political leadership together with domestic incentives explain the outcomes of foreign policy (Orban, 2008: 166). To explain when the domestic or international politics predominate the foreign policy preferences I have used Gerry Alons's model of external/internal polarity. Equally to other theories, the model has been used in a rather simplistic way. The core idea in the model is that the more capabilities the state has, the better it will be equipped to defend its national interests on the international arena. Alons defines this by the internal polarity; which in other words means the concentration of power in the hands of state, relative to other groups (Alons, 2007: 216). Analyzing this hypothesis I have concentrated on the power distribution between the Russian state and the private oil companies.

Two factors are important in Alons's model: the power distribution on the domestic level and the power distribution on the international level. The neoclassical realism adds the perception of the state leadership as an independent variable in explaining foreign policy outcomes. Alons uses his model to construct four possible combinations of external and internal polarity. Each combination can serve as an indication on what will determine the foreign policy preference, the domestic or the international variable (Alons, 2007: 222). Thus, the task was to define what the Russian internal and external polarity was when the decision to stop the transit was taken. The analysis has shown that state power consolidation under the first presidency of Putin affected also the oil industry, which according to the model resembles to the high internal polarity. There is no theoretical agreement on whether the international system was unipolar, with the USA as a leading power, or multipolar, with China, India and the EU as several power poles. In this case it is important how the Russian leadership perceived the power distribution on the world. And Putin's first presidency, the time I am writing about, is by many described as a pragmatic one, where the leadership attached more attention to economic growth and had a sober view on what the power distribution in the world was. (Jørgensen, 2003: 81). The NATO enlargement with the Baltic States can only strengthen this assumption. However, the geopolitical ambitions of the Russian state, can by no means be put aside, as Putin had by several occasions expressed the dissatisfaction

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with the real power distribution and the place Russia had on the international arena (Skak et al, 2005: 96-97).

Putin's view on a strong economy as a tool to restore Russia's influence abroad leads me to the discussion of what resource the oil transit has for the state authorities. What is the core potential importance of the oil industry? The obvious answer is that the oil sector is important in Russia's economy, as it stands for a large proportion of the incomes to the budget. On the other side, the oil industry has a potential for gaining political power and the case of Yukos has strengthen this idea.

Putin consolidated power quickly after becoming a President in 2000. He was explicit in his understanding of natural resources in Russia's development, saying that natural resources should be first of all used to the welfare of Russian citizens, not the single oligarchs. Whether these statements are just rhetoric, is not a question to answer in this thesis; what is important here is that this proclamation has turned into power consolidation in the energy sector. In the oil industry, in particular, Russia's overarching goal has become to prevent the breaking of a monopoly on the oil pipeline system. The clashing interests of Yukos and state Transneft when Yukos planned new pipeline to Murmansk can illustrate this point. The Yukos projected pipeline to Murmansk would have significantly expanded the oil export capability of Yukos and diminished the state's ability to control it. However, the project was never realized.

Thus, the main idea in this hypothesis is that Russia wanted to gain more control over the oil industry as the oil industry has both an economic and a political importance within the Russian state. The diversification of its transit system was a tool to tighten control as the state and the private oil sector has had different priorities in the transit policy. The private oil companies were satisfied with the export through Ventspils, an assumption that is supported by their negative reaction to the decision to stop using Ventspils. On the other side, the Russian state was pushing for to the use of national transit assets as it could increase state control over the private oil sector. In other words, Russia would have circumvented the third parties in the transit routes by all

means possible, even if it had harmed the economic position of its oil companies. To take control over the oil industry can be in turn embedded in the long-term goal to restore Russia's international influence; the strong economy is therefore a tool to realize this goal.

Unlike the two other hypotheses, where I was searching for the change in political or economic conditions that could provoked the decision to terminate the transit, the main task here was to identify whether this decision can be embedded in the general Russian strategy to avoid third parties in transit routs. Two factors strengthen this hypothesis: firstly, the Russian authorities have long before the VN case expressed the necessity to divert the transit to Primorsk; secondly, no attempt to renew the transit to VN was made in the following years.

### 7.3 The motivation to turn down the transit: different starttng-points in the hypotheses

The initial starting-points for my three hypotheses are explicitly different. All three hypotheses try to explain the same event by looking on different aspects and from different perspectives. Firstly, I have assumed that Russia stopped the transit because it *wanted* to defend its national security interests in the region as NATO was enlarging and Russia condemned the minority policies of the Latvian governments; thus, the transit could be used in political terms. The main challenge in this hypothesis was to understand the rationale if the motivation was to defend the national interests, as NATO was to be expanded and there was nothing the Russian authorities could have done to prevent it. Consequently, I concluded that the motivation could be as simple as the wish to punish, at least economically.

Secondly, to stop the transit was something Russia *needed* to do, because the economical aspects, such as ownership in VN and the tariff policy have been a matter of concern. In this way, the actions taken on the Latvian sub-national level could have provoked the reaction to cut down the oil flow. The privatisation of VN seemed to be

a Gordian knot in the transit relations between Russian state and Transneft and Latvian Ventspils Nafta. On the other side, to lose an important export facility that damages the interests of major oil companies, has no rational explanation; at least it was supposed to be understood as a “necessary evil” to reach some other, long-term goals, the assumption that leads us to the last hypothesis.

Finally, to stop using the Ventspils route could be something the Russian state *must* have done, as it saw the necessity to tighten its control over the oil industry. The transit in this hypothesis is used as an example of clashing interests between state-owned Transneft and Yukos, the company that had planned to build its own pipeline system to the seaport of Murmansk. State power consolidation in the energy sector could be explained by the awareness what potential for political power the oil industry has.

## 7.4 The reaction to stop the transit generated by a set of cumulative factors

To reach geopolitical, political or economic goals, Russia might have used such problems as technical disadvantages of the Latvian pipeline, contractual disputes between Ventspils Nafta and Transneft and discriminatory price policy. However, as the analysis has shown, this explanation is not without controversies. The immediate reasons for such behaviour therefore appear to be both political and economic. As far as economic motivation in the decision to turn down the oil transit to Latvia can have a legitimate ground, the political underpinnings could be understood as an expression of Russian long-term geopolitical and strategic goals (Larsson, 2006:5).

Putin has a particular view about the role of the state in the energy sector. In his view, oil and gas reserves should belong to the state, not the private sector, and the state should develop these resources for the national interest, not those of private oil and gas companies. The part left for international companies is to provide the technology

and the capital, to be service-providers and financiers to enable the state to maximize the benefits of the reserves for itself (Orban, 2008: 63).

Can Russia be considered as a unified actor in its energy policy as the rational actor model predicts? It is obvious that the Kremlin has the ultimate responsibility and experiences a great influence over key oil companies, although several companies have reacted on the transit stop by writing a protest note to the Government Commission.

What about the private oil sector, has there been cohesion among them? The facts show that the Russian oligarchy is not a unified group ready to defend itself. While some, as Lukoil heads, sided with the Kremlin after Yukos was overtaken by the Russian state, others have been preparing to liquidate their assets and move their capital out of Russia (Cohen, 2007).

This thesis has illuminated the fact that Russia sees its energy policy in a strategic and security perspective. Its fundamental task is to ensure national security. Political and economic actions are therefore meant to support this overarching idea. Energy seems to be utilised to avert threats and extend Russia's influence abroad. This tendency can be observed in the official statements of the President Putin. The energy sector, as Putin has stated, is "aimed at furthering the geopolitical interests and maintaining the national security of Russia" (Putin in Larsson 2006: 270). However, to take this explanation as a key one would be too simplistic. Therefore, I conclude that the transit cannot be explained by any single hypothesis, but rather all three of them taken together. Each hypothesis has come with different explanation and has focused on different actors on different levels. The objective of this thesis has not been to test the hypothesis against each other, but to reveal how much each of them can contribute to explain the main question.

Consequently, one may argue that the core problem in Latvian-Russian energy dialogue has been the Russian attempt to gain control over the Ventspils Nafta. Although the official reason for the oil blockade was the claim that Ventspils`tariffs

are too high, compared to tariffs at Primorsk, the political underpinnings may be made because of the fact that Repse's deny to privatise Ventspils Nafta was followed by the decision of the Russian government to increase the capacity of Primorsk, putting the deadlock on the future flow of oil to Ventspils. This underlines that the timing for Russia's oil cuts has been politically crucial.

However, both the political tensions in the foreign policy between Russia and Latvia and the privatisation process of VN were long-lasting events, that can be described more or less even and stable, than rapidly shifting as the relations between two countries were changing. Moreover, the oil flow was slowly reducing throughout 2002, what can be both interpreted as a mean to press Latvian actors to change their privatisation strategy, but can also be understood as a natural development, because the oil shipment to Primorsk was gradually increasing. The determination to avoid third parties in oil transit has been on the agenda long before the Ventspils was taken off the transit route<sup>16</sup>. Therefore, the decision can be understood as an expression of long-term internal interest, but the timing when the decision was taken can be explained by two other hypotheses.

Some time has passed since the transit of the Russian oil stopped and significant changes have happened both within these two countries and in the relationship between them. Latvia is today a full member of NATO and the European Union and Russia has experienced years of economic growth and political stability. In the transit sector, Russia is holding the course towards developing its own seaports and is searching new ways of transporting its natural resources to the world markets<sup>17</sup>. Time has revealed that there is no Russian interest to renew the transit.

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<sup>16</sup> P. Rodionov, the Russian Minister for Fuel and Energy, has as early as in 1996 expressed that Russia, which has potential to use its own export routes, should have concentrate on using them instead of foreign facilities (Spruds, 2001:5).

<sup>17</sup> Nord Stream project of exporting Russian gas through the pipeline constructed on the bottom of the Baltic Sea is an example of Russian strategy to diversify its transit routes and avoid third parties in export.

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